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Economic conditions, lending competition, and evaluation effect of credit line announcements on borrowers[☆]

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ABSTRACT

This paper examines the determinants of the signaling effect of acquiring lines of credit (LCs) on borrower stock returns by testing the economic conditions and lending competition hypotheses. The economic conditions hypothesis is tested by examining the loan cyclicality and handpicking effects. The former predicts a negative relationship between economic conditions and borrower returns because of banks' loose (strict) screening practices in a booming (recessionary) economy, whereas the latter expects a positive relation around the time of the LC announcements. The lending competition hypothesis proposes that the more competitive the lending market is, the looser the banks' screening practices will be. Thus, a negative competition-borrower relation will result. Using LC data from 2001 to 2010 concerning 501 stock-listed firms in Taiwan, we find that evidence supports the lending competition hypothesis and the handpicking effect of the economic conditions hypothesis.

1. Introduction

This paper focuses on the signaling effect of lines of credit (LCs) on borrower stocks. LC is a type of contractual commitment to lend up to a pre-negotiated amount at a certain interest rate in the future. Borrowers obtaining LCs from lenders have certain advantages, such as the ability to resolve financing problems resulting from credit rationing or the deterioration of credit worthiness (Campbell, 1978; Melnik and Plaut, 1986; Sofianos et al., 1990). Additionally, these borrowers can respond to the demands of working capital or capital expenditures to ensure short-run and long-run solvencies (Martin and

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Santomero, 1997; Mosebach, 1999).[1] LCs offer firms the opportunity to exploit future business opportunities available in good times (Lins et al., 2010). Because of these advantages, a borrower who has been granted LCs should have a good reputation from the viewpoint of the market.

Additionally, according to the signaling view, an announcement about LC grants provides information about the firm's quality to the market and thus reduces the information asymmetry between the observers inside and outside of the firm. Additionally, as suggested by Fama (1985) and James (1987), LC announcements allow banks to more completely capture information about a borrower's financial condition and prospects and therefore obtain a uniquely advantageous position of information symmetry. Mosebach (1999) even recognizes that the information banks possess about a borrower's credit worthiness can be considered as a piece of inside information. Hence, the market views a firm to be of high quality if the firm is granted LCs and the borrowers' stock prices positively reflect the value of the signaling effect. James (1987), Lummer and McConnell (1989), Slovin et al. (1992), Best and Zhang (1993), Preece and Mullineaux (1994, 1996), Mosebach (1999), and Gasbarro et al. (2004) all empirically demonstrate that firms' stocks gain significantly positive abnormal returns after the firms announce that they have been granted loan agreements.

Although announcements about granted LCs generally signal good information to the financial market, several factors influence the information content of LCs and cause different market reactions. Past studies have suggested that these factors include the borrowers' size, extent of popularity (Fama, 1985; Diamond, 1991; Slovin et al., 1992), profitability, and prospects (Best and Zhang, 1993; Martin and Santomero, 1997; Fields et al., 2006). In addition, the factors that affect a lender's ability to screen its loan applicants also influence the information content and the strength of its LC events. These factors include the lenders' size (Cook et al., 2003), reputation (Billett et al., 1995), loan loss reserves (Johnson, 1997), and identity (i.e., whether the lender is a bank) (James, 1987; Fery et al., 2003) as well as the number of associated banks with borrowers (Preece and Mullineaux, 1996; André et al., 2001; Fery et al., 2003).

The present paper intends to further investigate two additional factors that may also affect the borrower's stock price response to LC events. These two factors are the economic conditions and loan market competition, which have not been examined in the literature. Both factors may affect the degree to which banks screen their loan applicants (Borio et al., 2001; Berger and Udell, 2004). Further, André et al. (2001) argue that the degree to which banks screen their borrowers can positively impact the information content of the bank loan agreements. Therefore, the two factors will probably affect the information content of LCs via their effects on the extent of bank screening. Past studies have not examined the effects of these two factors. Thus, the impact factors that have been found in prior articles are not yet completely understood. In Taiwan, financial institutions are actively involved in mergers and acquisitions, and financial shareholding companies were established throughout the country in the early 2000s. This event caused the structure of financial competition to substantially change after that period. As a result, this period is relevant to our examination of the effects of LC events on market reactions. Therefore, the sample in this paper comprises the data on LCs granted by banks to publicly traded firms in Taiwan.

The present paper investigates two effects to test the economic conditions hypothesis: the loan cyclicality and handpicking effects. The former proposes that LC events signal weak information about borrower quality in a booming (recessionary) economy because lenders loosely (severely) screen their applicants in these conditions, whereas the latter suggests the opposite result. However, the economic conditions hypothesis may overlap with the business cycle effect, which also suggests a positive relation between economic conditions and borrower returns. To mitigate this concern, this paper focuses on the market-adjusted abnormal returns of borrowers' stocks, which can nullify the effects of the market performance and, in turn, the business cycle. Furthermore, if most of the banks adopt strict (loose) screening practices, the ability to screen borrowers will play a less (more) critical role in conveying information about borrower quality. This feature can be used to examine the two effects under both the economic conditions hypothesis and the lending competition hypothesis. Specifically, if the LCs granted by banks with superior screening abilities provide significantly (insignificantly) higher announcement abnormal returns in a recessionary (booming) economy, then the handpicking effect exists.

[1] Recent empirical evidence suggests that access to LC depends on the borrower's credit quality and the lender's financial condition. An LC is an imperfect substitute for cash as a source of corporate liquidity (Demiroglu and James, 2011).