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The link between bank monitoring and corporate dividend policy: The case of dividend omissions

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Abstract

This study investigates whether bank monitoring influences investor response to a borrowing firm's decision to omit its dividend payments. We establish a new link between the theories of banking and dividend policy in an examination of how bank monitoring and firm dividend signals complement one another to resolve information asymmetries. Results indicate that, for small firms, investors interpret the dividend decision as a function of bank monitoring and the dividend signals taken together. Also reported are the results of tests examining the differences between the monitoring effects of banks versus public and private non-bank lenders. © 2001 Elsevier Science B.V. All rights reserved.

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1. Introduction

The purpose of this study is to investigate whether bank monitoring influences the market's response to a firm's decision to omit its cash dividend. In particular, this study establishes a new link between the theories of banking and dividend policy by examining how bank monitoring and dividends as signals may complement each other in mitigating information asymmetries.

Information-based theories of financial intermediation suggest that banks provide a unique information production and monitoring service in an informationally asymmetric capital market. [1] These theories imply that an imperfect capital market recognizes the value of bank monitoring and uses bank debt as a signal of firm value.

A number of empirical studies show that the presence of a bank lending relationship disseminates information about the firm that influences the market's assessment of major corporate decisions. [2] For example, studies have shown that the presence of bank debt affects the market assessment of corporate selloff decisions, the issuance of commercial paper, and seasoned equity offerings. Other studies have demonstrated a relationship between bank debt, firm value, and the underpricing of initial public offerings. In short, the theoretical basis and empirical evidence suggest that bank debt serves as an important signal of firm quality and thus contributes to reducing information asymmetries.

Research also suggests that the benefits of banks as information specialists and monitors of corporate activity may have the greatest effect on small firms (e.g., Fama, 1985; Slovin et al., 1992). Whereas much information may be available about large firms, providing them easier access to capital markets, small firms are less well known. Hence, their ability to obtain credit from banks may serve as a signal of value. It is in this context that we study the interaction between firm size and banking relationships.

In previous studies of payout policy, various theories have been set forth to explain the relationship between dividends and firm value. Signaling theory suggests that in a market characterized by asymmetric information, dividends can be used as a signaling device to communicate private information. In general, dividend-signaling models posit that dividend announcements convey information about the firm's current and/or future cash flows, therefore changes in the value of the firm around the time of dividend announcements should be proportionate to the unexpected change in dividend policy (e.g., Bhattacharya, 1979; Miller and Rock, 1985; John and Williams, 1985).

[1] Much of this literature is reviewed in Bhattacharya and Thakor (1993).

[2] See, for example, Hirschey et al. (1990), James (1987), James and Wier (1990), Slovin et al. (1988), Slovin et al. (1990) and Slovin and Young (1990).