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A note on: Capital adequacy and the information content of term loans and lines of credit

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Abstract

This study examines the information content conveyed by the disclosure of credit agreements in a Canadian setting. We argue that the introduction of the 1988-capital adequacy requirements lead banks to reduce their level of commitment at the issuance of lines of credit to avoid their inclusion in the calculation of the capital ratio. As a result, after 1988, the disclosure of lines of credit is expected to be less informative than the disclosure of term loans since banks may exert less effort to screen and monitor firms. Our results are consistent with the argument that the difference between the market reactions at the disclosure of term loans and lines of credit is significant after 1988. We also provide evidence that firm size and concentration of borrowing affect the market reaction at the disclosure of bank credit agreements. © 2001 Elsevier Science B.V. All rights reserved.

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1. Introduction

Bank credit agreements (term loans and lines of credit) provide firms with important access to capital. These agreements, when disclosed, can provide a signal to the market of firms' ability to raise capital and banks' assessment of firms' value (Fama, 1985; James, 1987; James and Wier, 1990; Slovin and Young, 1990; Lummer and McConnell, 1989). The empirical evidence indicates that the characteristics of both banks and firms can affect the degree of informativeness of bank credit agreements (Johnson, 1996; Preece and Mullineaux, 1996; Petersen and Rajan, 1994). The empirical findings also suggest that the informativeness of bank credit agreements depends on how well firms are monitored (Slovin et al., 1992; Best and Zhang, 1993).

In this paper, using a sample of Canadian firms, we examine the relationship between the informativeness of credit agreements and banks' level of commitment. Banks' level of commitment at the issuance of a credit agreement is affected by several factors such as time to maturity, the collateral offered on the loan, and their ability to unconditionally cancel the credit agreement. If banks reduce their level of commitment when providing financing, their risk exposure would be reduced which may lead them to exert lower effort in screening and monitoring firms. In such a case, we expect to observe a lower market reaction at the disclosure of bank credit agreements.

In 1988, Canadian authorities changed the capital adequacy requirements to adopt the recommendations of the Bank of International Settlements. We argue that the introduction of the 1988-capital ratio results in a reduction of banks' level of commitment at the issuance of lines of credit so that they can avoid some costs associated with the issuance of off-balance sheet instruments. Therefore, by comparing the information content conveyed by the disclosure of term loans and lines of credit before and after 1988, we can test the impact of banks' level of commitment on the market reaction at the disclosure of bank credit agreements. [3]

Our sample consists of 122 announcements of new and revised bank credit agreements in the Canadian market during the period 1982–1995. Our results indicate that the information content conveyed by the disclosure of lines of credit differs before and after 1988 for small firms. The information content conveyed by lines of credit and term loans for small firms differs after 1988, but not before. Furthermore, the information content conveyed by term loans

[3] The conditions on the credit agreements can be used as proxies for bank's level of commitment. Those conditions include, among others, time to maturity, the collateral offered on the loan, and their ability to unconditionally cancel the credit agreement. However, in our sample of announcements, information with respect to the time to maturity and the collateral offered on the loan are not always disclosed, and information on banks' ability to unconditionally cancel is not available.