



Political uncertainty and bank loan contracting

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ABSTRACT

Given that political uncertainty greatly impacts firm level investment decisions, this paper examines whether and how political uncertainty influences a firm's cost of bank loans. We create a novel measurement of individual firm's exposure to political uncertainty and find that fluctuations in the political environment impose additional costs on the loan contract. Economically, a one standard deviation increase in a firm's idiosyncratic political exposure is related to 11.90 basis points of additional spreads. In addition, related lenders have an information advantage in pricing a borrower's future political exposure, while non-related lenders do not have such an advantage. On the supply side, lenders with higher political exposure also request additional loan spreads.

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1. Introduction

"... The focus of the last couple of years on borrowing costs for peripheral members of the euro zone was, in retrospect, unfortunate. ... Banks are hesitant to lend. On Thursday, the European Central Bank report on loan activity in September showed a record 1.4 percent year-over-year decline in loans outstanding to private sector companies and individuals in the euro zone..."

— Floyd Norris, Oct 25 2012, *The New York Times*¹

Political uncertainty arrives with both accidental and scheduled political incidents, and inflicts significant impacts at the firm level. Certain political conditions produce additional risk that may result in a bad state of outcomes or change the ranking of outcomes for potential projects. Recognizing this, firms may postpone investment decisions until significant political uncertainty is dissolved (Bloom et al., 2007). Julio and Yook (2011, 2012) document a 4.8% reduction in firm level investment and cross-border capital flow in election years. Durnev (2010) finds that a firm's investment sensitivity to stock price is reduced by 40% during presidential elections. Shareholders hence adjust their expectations on firm value based on how the political environment will affect firms' cash flows, and consequently demand extra compensation for bearing the additional political risk (Pástor and Veronesi, 2013).

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¹ <http://www.nytimes.com/2012/10/26/business/euro-avoids-collapse-but-its-future-remains-uncertain.html>.

Debt holders are in a similar situation. When firms' future cash flows change, firm's default risk is affected as well (Nini et al., 2012). This paper aims to fill a gap in the literature by investigating whether and how political uncertainty affects the cost of bank loans. This question is important for a number of reasons. First, the bank loan is one of the most important forms of external financing in the U.S., and the cost of debt is closely related to firms' investment decisions and performances. Second, the loan contract reflects the information asymmetry between the parties and incorporates a lender's prospect of firm exposure to the political conditions.

We construct two measures for a firm's idiosyncratic exposure to the political environment, capturing the firm's ex-post and ex-ante political exposure using the sensitivity of the firm's stock returns to the changes in the *Political Uncertainty Index* (Baker et al., 2012). We find that, in general, firms with higher exposure to political uncertainty are subject to higher costs of loans. Economically, a one standard deviation increase in the ex-post exposure is associated with 11.90 basis points of additional loan spread. In addition, consistent with Sufi (2007), we find that related lenders with less information asymmetry are able to price firm's future exposure (ex-ante) to the political uncertainty. We also find that lenders' political risks are relevant for loan contracting. Lenders with higher political exposure request a higher cost of loan from borrowers. This mitigates the concern that the previous results are driven by lenders' political risks in cases which borrowers and lenders have similar political risks under certain conditions. Through a number of robustness checks, we find that our results are not driven by the time period with high political instability, or firms' general systematic and idiosyncratic risks.

By providing direct evidence on how political uncertainty impacts cost of loan, this paper makes several contributions to the literature. To the best of our knowledge, it is the first attempt to examine private debt contracting in the context of political uncertainty. Second, this paper contributes to the literature of political uncertainty in general. Our findings are closely related to prior works that investigate how political conditions impact firm operations and performance. Our findings open a new avenue in understanding changes in firm decision-making and firm performance under political instability from the perspective of the cost of capital. Third, this paper implements a novel measure of political exposure that captures firms' idiosyncratic political risks, which again renders our results more general.

There are two papers that are similar ours: Qi et al. (2010) and Gao and Qi (2013). Both find that political uncertainty has a negative impact on bond yields. However, our paper differs in several ways. First, we look at the private debt market, in which lenders have more incentive to monitor; second, we use a time-series measure of political uncertainty instead of the binary indicator of elections (Gao and Qi, 2013) or cross country variation in political rights (Qi et al., 2010). Third, we provide evidence on how political uncertainty impacts the cost of debt from the supply side.

The rest of the paper proceeds as follows. Section 2 describes the sample, measurement, and methodology. We provide the main results in Section 3. Robustness checks and discussion are conducted in Section 4. Section 5 concludes.

2. Sample, measurement and methodology

We begin constructing the sample with private debt contract information from Loan Pricing Corporation's Dealscan. Dealscan provides comprehensive coverage of the bank loan contracts. We follow the literature (e.g., Nini et al., 2012; Sufi, 2007) and restrict the sample to 1990–2010, as the information before 1990 is limited. We match the Dealscan and Compustat with the Dealscan–Compustat Link Data from Michael Roberts (Chava and Roberts, 2008). This matching process yields detailed information on 52,967 loan facilities of 7,947 firms.² Table 1 presents the summary statistics. The means by which we calculate variables are detailed in the Appendix A. Political exposures are measured using the model detailed in the next subsection. The average loan facility in our sample is priced at 204 basis points (above LIBOR).

We use the monthly *Political Uncertainty Index* compiled by Baker et al. (2012) as the proxy for the *general level* of political uncertainty.³ With the index, we construct the *monthly percentage change* of the political conditions (R_{Pt}).⁴ More specifically, we divide the monthly change of political uncertainty level (from the end of previous month to the end of current month) by the political uncertainty level from the end of previous month. Then, we measure each firm's idiosyncratic political exposure with the following model, in a fashion similar to how the literature measures exchange rate exposure (Jorion, 1991).

$$R_{it} = \alpha + E_{Pi} \cdot R_{Pt} + \gamma_{Mi} \cdot R_{Mt} + \gamma_{Si} \cdot SMB_t + \gamma_{Vi} \cdot HML_t + \varepsilon_{it} \quad (1)$$

in which, R_{it} is firm's monthly stock return (over the risk free rate) R_{Pt} is the *monthly percentage change* in the political index. R_{Mt} is the monthly CRSP value weighted market return (over the risk free rate). SMB_t and HML_t are the Fama-French factors for size and value

² The actual observation used in each regression varies because of missing values. Also, we calculate firms' ex-ante political exposures using the stock return information for 36 months *succeeding* the loan origination. Thus for tests involving ex-ante exposure, our sample is limited to the 1990–2007 period. The frequency of our observation at the firm level is aligned with the frequency of the issuance of private loan contracts of the underlying firm. It varies across firms, and we may have several observations for one firm-year if the firm signs more than one loan contracts.

³ The index measures the monthly variation in political conditions from 1985 to 2010. It consists of three major parts: an index of Google News search results that counts the month-by-month search results of news-containing terms related to economic and policy uncertainty (adjusted by the total number of articles in the month); the scheduled expirations of federal tax code provisions provided by the Joint Committee on Taxation; and the disagreement in the forecasts of two measures: consumer price index (CPI) and federal purchases of goods and services one year in the future. The index is then computed using weights of 1/2 on the Google News-based policy uncertainty index and 1/6 on each of the other three measures (tax expirations index, CPI forecast disagreement measure, and federal purchases disagreement measure). A larger number implies a higher level of political uncertainty.

⁴ We also use the monthly innovation from an AR(1) model to capture the change in the level of political environment. All the main results remain unchanged. The time-series pattern of the *Political Uncertainty Index* can be found in Baker et al. (2012).

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