How Much Liquidity Insurance Do Lines of Credit Provide?[*]

Zhaohui Chen
McIntire School of Commerce
University of Virginia

Yan Hu
Temple University & University of Minnesota Duluth

Connie Mao
Temple University

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[*] Zhaohui Zhen, McIntire School of Commerce, University of Virginia, Charlottesville, VA 22903. Tel: (434) 243-1188; Email: zc8j@comm.virginia.edu. Yan Hu, Department of Finance & MIS, Labovitz School of Business and Economics, University of Minnesota Duluth, Duluth, MN 55812. Tel: (218) 726-7083; Fax: (218) 726-7516; Email: huyan@temple.edu. Connie X. Mao, Department of Finance, Fox School of Business and Management, Temple University, Philadelphia, PA 19122. Tel: (215) 204-4895; Fax: (215) 204-1697; Email: cmao@temple.edu. We would like to thank Lalitha Naveen, David Reeb, Elyas Elyasian, Warren Bailey, and seminar participants at Temple University and University of Minnesota Duluth for their helpful comments and discussions. All errors are solely ours.

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Abstract

Theoretical literature argues that firms are (weakly) better off securing line of credit than holding cash to insure against future liquidity short-fall. On the contrary we find that lines of credit provide limited liquidity insurance relative to cash. The limits are imposed by agency problems between bank and firm. Insurance provided by a line of credit is limited in at least two dimensions. First, firms may not be able to draw down at the low rates specified in the contracts. In particular, firms need liquidity the most get little insurance benefits. Second, firms can only take advantage of lower than market borrowing rates for a relative short period of time. They have to pay higher than market rates once they renew lines of credit. The limits suggest that firms relying on lines of credit for their liquidity need may be forced to forgo positive NPV projects. Bank reputation and lending relationship help improve the efficiency. Our finding provides an explanation on firms' trade-off between cash and line of credit in liquidity management.