Corporate Cash Hoarding During Times of Uncertainty – The Case of Covid-19

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Money, we are told, must be put to productive use, i.e., invested. Storing money under your pillow, is linked to opportunity costs like the foregone return on assets and potentially, taxational drawbacks.

The principal agent theory explains why firms may hold sub-optimally high levels of cash; managers have a preference for cash since it reduces corporate risk and adds to their discretion. But the literature also points to the role of financial constraints for corporate cash holdings stating that a precautionary motive may be driving cash accumulation; the company can use the cash to finance its operations and capital expenditures when other sources of financing are not available or are prohibitively costly.

If firms could be sure that they would always have access to funds at a reasonable price, they would invest all their cash except for the liquid funds indispensable for transactions. The price of financing is in turn strongly influenced by the business cycle, during booms investment and the number of loans go up, as well as a firm's credit rating, the better the rating the easier it is to obtain external funds.[1]

Having a good credit rating especially comes in handy during times of heightened aggregate risk as banks and investors become particularly cautious, which suggests that only higher-rated firms will generally be able to get financing from the bond and the equity capital markets.[2] Moreover, firms rated just above the non-investment grade face an increased sudden risk of failing to meet their credit eligibility criteria and being downgraded, which, anticipating this, makes them particularly susceptible to amass liquid funds. Such potential "fallen angels" are even more cash-hungry than non-investment grade firms since the latter do not face the "cliff risk" of forfeiting access to the bond and equity capital markets or facing increased funding costs which just above non-investment grade firms are exposed to. These mechanics were bluntly brought to light during the first lockdown of the Covid-19 Pandemic, which uncovered some of the cracks hidden in the debt market.

In late February of 2020 the US-President declared that *"It's going to disappear. One day — it's like a miracle — it* [Covid-19] *will disappear"* but throughout March and April most states issued stay-at-home orders and businesses deemed nonessential were instructed to close. The virus-induced distress spread to not only the general public but also the corporate world. The shutdown of the economy catapulted the majority of firms into an impending liquidity crisis. As they experienced a sudden and exogenous increase of their default risk, they drew down their credit lines at an unprecedented scale. *"People got scared"*, said Jamie Dimon, the CEO of JPMorgan. He stated that the drawdown rate was twice what it had been during the Great Financial Crisis of 2008, and that companies were stockpiling cash reserves to brace for a lengthy and sluggish journey out of the economic freeze.[3]

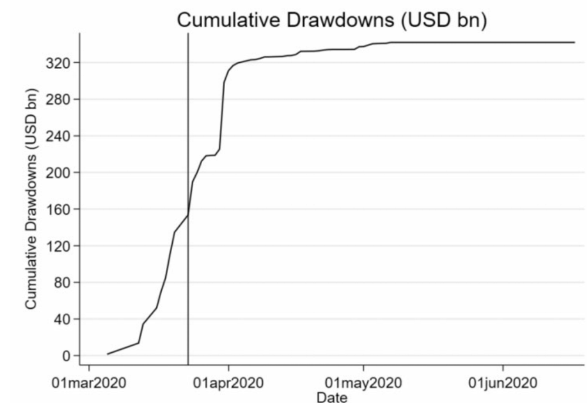

Figure 1: Cumulative Aggregate Credit Line Drawdowns. (Acharya & Steffen, 2020, p. 35)

Figure one shows the aggregate cumulative drawdowns of 1,971 nonfinancial publicly listed US firms that at the beginning of 2020 had assets worth at least $100 million from March until June 2020, Figure 2 illustrates the cumulative drawdowns for the different rating classes. The vertical line marks the announcement of the Fed's corporate bond-buying program.

In March all firms, including AAA-A rated ones, drew down their credit lines totaling $336 billion

[1] Credit Rating agencies have come in for a lot of criticism after the Great Financial Crisis of 2008, the main points being that they have an incentive to give a good rating to the one who pays, i.e., the firm and that their employees may want to give a favorable impression to their potential future employer. But it seems that credit rating agencies still enjoy trust where it matters – on the debt market.

[2] In the following I draw from Acharya, V. V., & Steffen, S. (2020). The risk of being a fallen angel and the corporate dash for cash in the midst of COVID. The Review of Corporate Finance Studies, 9(3), 430-471

[3] Flitter, E. (2020, April 14). Big Banks, Readying for a Recession, Set Aside Billions. New York Times. Retrieved from https://www.nytimes.com/2020/04/14/business/bank-earnings-jpmorgan-wells-fargo.html

eclipsing credit line drawdowns of the Great Financial Crisis of 2008. What becomes evident from Figure 2 is that in March non-investment grades and BBB-rated firms drew down at a much higher intensity than AAA-A rated and unrated firms. BBB-rated firms showed an initially even greater appetite for liquidity than non-investment grades, pointing to the downside of becoming a fallen angel and facing the "cliff risk" of either being excluded from or encountering increased costs on the equity and public debt markets. Indeed an enormous gulf in stock performance opened up between fallen angels and their BBB rated counterparts in March, as Figure 3 illustrates. What is more, BBB rated firms, although lacking behind AAA-A rated firms, were eventually able to issue bonds at a larger scale while bond issuance by non-investment grades never got off the ground.

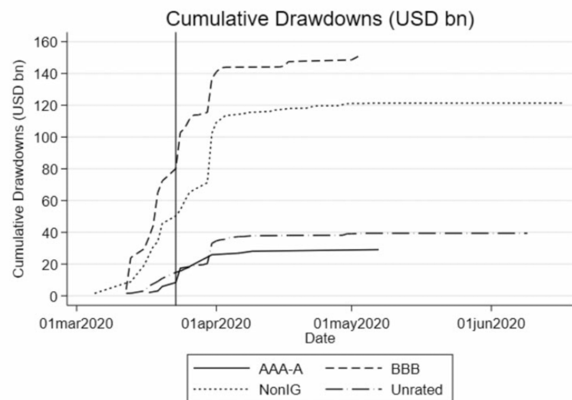

Figure 2: Cumulative Credit Line Drawdowns by Category. (Acharya & Steffen, 2020, p. 35)

AAA-A rated firms suffered less of a slump on the stock market and were able to issue bonds and equity most successfully, especially once the FED launched its corporate bond buying program (see Figure 4) thus relaxing their credit line drawdowns towards the end of March and resorting to the

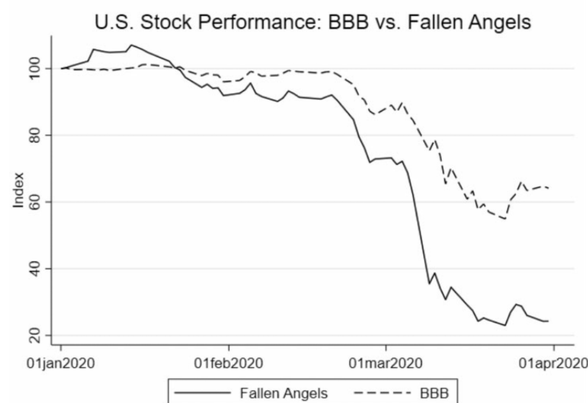

Figure 3: Stock Price Performance by Rating Class. (Acharya & Steffen, 2020, p. 40)

public capital and equity markets. However, non-investment grades and firms without a rating and to a lesser extent BBB rated firms continued drawing down their credit lines well into April. This development is neatly summarized in Figure 5, which shows the daily credit line drawdowns as a share of the credit limit (left-hand scale) along with their z-score (right-hand scale), a linear combination of ratios pertaining to profitability, leverage, liquidity, solvency, and efficiency to foretell whether a company stands a high chance of defaulting. The vertical line again marks the announcement of the FED's corporate bond buying program.

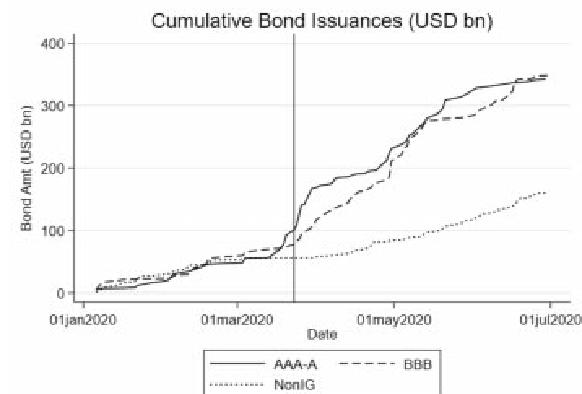

Figure 4: Cumulative Bond Issuances. (Acharya & Steffen, 2020, p. 38)

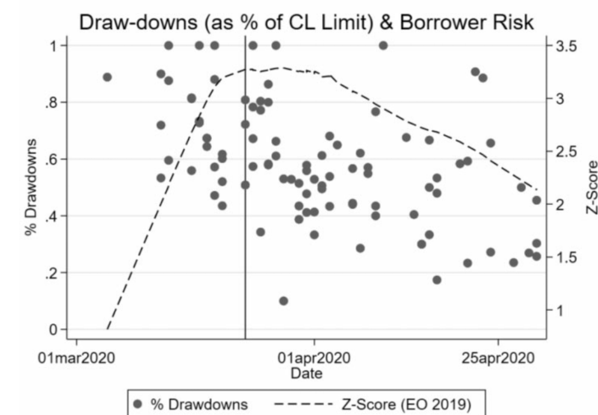

Figure 5: Drawdown Percentage Rate and Borrower Quality. (Acharya & Steffen, 2020, p. 37)

During March the average quality of the lenders improved until the FED's announcement which is when AAA-A rated firms turned to equity and public debt markets. After that the drawdown intensity and the quality of borrowers gradually decreased as more stabilization measures were introduced and BBB-B rated firms issued bonds more successfully.

To sum up, when uncertainty was at its peak, all firms hastily turned their credit lines into cash. Towards the end of March better rated firms increasingly sought financing on the equity and public debt markets. Stock prices in all categories plummeted with a wide gap opening up between BBB rated firms and the formerly BBB rated fallen angels. BBB rated firms faced the unique risk of a downgrade into the non-investment grade zone which is arguably why, out of all the different rating categories, they stockpiled the most on cash. Although stabilization measures taken by the FED seem to have attenuated the crisis, different firms were affected differently raising questions about the advantages and disadvantages of targeted policy measures as well as their feasibility during times of elevated aggregate risk.

The economic stress caused by Covid-19 put the resilience of the banking system to the test. Fortunately, banks stayed above their minimum capital requirements, a possible reason being that banks were better capitalized than before the Great Financial Crisis of 2008. Covid-19, however, also laid bare the power of credit ratings and their impact on firm behavior. The fact that BBB rated firms drew down more than non-investment grades in March and April points to a possible inefficiency in the debt market; BBB rated firms ought to be in better shape than non-investment grades, so why should they be in greater liquidity needs? Should they have been labeled investment-grade to start with? Should credit ratings put downgrades on halt during times of extreme uncertainty? How can they provide reliable ratings while avoiding a bank run by borrowers? Are we bound to witness a run on credit lines every time a black swan appears on the horizon and downgrades loom?