

Aggregate Risk and the Choice Between Cash and Lines of Credit

by

Viral V Acharya, Heitor Almeida and Murillo Campello

Abstract:

We argue that a firm's aggregate risk is a key determinant of whether it manages its future liquidity needs through cash reserves or bank-provided lines of credit. Banks create liquidity for firms by pooling their idiosyncratic risks. As a result, firms with high aggregate risk find it costly to get lines of credit from banks, and opt for cash reserves in spite of higher opportunity costs and liquidity premium. We verify this hypothesis by showing that firms with high asset beta have a higher ratio of cash reserves to lines of credit, controlling for other determinants of liquidity policy. This effect is true at the firm level as well as the industry level, and it is significantly stronger during recessions when aggregate risk tends to increase.