Corporate Governance, Cash Holdings, and Cost of Debt

Abstract

This paper examines how governance affects relations between cash holdings and cost of debt. We use the credit default swap spreads as the proxy of cost of risky debts. Intuitively, larger cash holdings should improve firms' readiness for contingent cash-demand, hence the swap spreads should decrease with cash holdings. Such an intuition, however, is not consistent with data which rather exhibits non-monotonic U-shaped relation between the swap spreads and cash holdings. We also find the U-shaped relation between governance scores and the debt cost. We propose and empirically examine a mechanism where cash holdings endogenously determined by governance structures determine the swap spreads. This governance-associated mechanism is found to be behind the ambiguous U-shape. We also find the quality of capital investment decision is one of important determinants of the risky debt cost, whereas cash holdings are found not to affect the swap spreads. The significance of the mechanism is found to be robust to samples sorted by governance scores or credit ratings, too. These findings suggest that governance as well as management's capital budgeting quality fundamentally determines cost of risky debt and that cash holdings are not related to the cost of debt.