A note on market response to corporate loan announcements in Canada

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Abstract

This note validates the key results of prior studies of bank loan announcement effects using a common data set drawn from the Canadian capital market. Announcements of bank loans are associated with positive abnormal returns significantly higher than for private placements and loan syndications. Announcement effects are most pronounced when monitoring is most intense and when an announcement signals that the bank’s private information is favorable. Conclusions of prior studies on bank loan announcements, conducted exclusively on US data, are robust for a different banking system. © 2000 Elsevier Science B.V. All rights reserved.

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1. Introduction

There is now quite a large literature examining the effect of the announcement of a loan agreement or loan renewal on the equity price of the firm. The aim of these studies is to test the theoretical hypothesis that bank lending is different from non-bank lending (either through public debt or non-bank
private placements) in that it provides unique monitoring services. The main finding of these investigations is to document that, indeed, the announcement of a bank loan agreement or the renewal of an existing one (at the same or better terms) elicits a positive reaction in the market value of the equity of the borrowing firm. These findings have been further confirmed by studies showing that positive announcement effects are stronger when the borrowing firm is smaller, the lender is more reputable, and the loan is not syndicated.

This paper re-examines these issues in the context of a Canadian data set making two contributions: First, it explicitly examines whether the theoretical predictions, tested for the US, also hold in another country with a different banking system. Second, the data set employed allows a joint test of different hypotheses, thus facilitating a broader and more comprehensive analysis.

The main findings are that the effects documented for the US are also verified in Canada for companies traded on the Toronto Stock Exchange. Further, we find that the positive announcement effect decreases with the quality of the borrowing firm and with the maturity of its debt.

The remainder of this paper is organized as follows. Section 2 reviews prior evidence on loan announcements and formulates the hypotheses to be tested. In Section 3 we describe the sample selection and the methodology. An analysis of the empirical results is in Section 4. Section 5 reports the results of a cross-sectional regression. Section 6 presents the conclusions and discusses issues for future research.

2. Prior studies and hypotheses

Fama (1985) suggests that banks are “special”, because they have a comparative cost advantage over other financial intermediaries in monitoring loans. James (1987) expands on the “uniqueness” of bank loans observing that banks provide special services that are not available from other lenders. He finds a positive stock price response to the announcement of bank loan agreements, and a negative response for private placements.

Diamond (1991) discusses the criteria which firms use in order to choose between bank loans and publicly traded debt. He concludes that, if moral hazard is widespread, new borrowers will begin to acquire reputation by being monitored by banks and later switch to issuing directly placed debt. Chemmanur and Fulghieri (1994) add the possibility of renegotiating the debt contract in the event of financial distress. They suggest that banks have an advantage over bondholders because of their ability to acquire a reputation for financial flexibility when confronted with firms in financial distress. They find that firms with a greater probability of being in financial distress choose bank loans, and those with a smaller probability issue publicly traded debt.
Consistent with theoretical emphasis on delegated monitoring arising from bank relationships, Lummer and McConnell (1989) show that announcements of new bank loans have no signaling effect, whereas favorably-revised bank credit agreements provide a positive signal to the capital markets. Best and Zhang (1993) refine this result to demonstrate that new loan announcements may convey positive information about the borrower when extensive monitoring is involved. Beyond monitoring, switching to a new bank can be advantageous when it allows a borrower to avoid rents being charged by a bank with which it had a long-term relationship. Houston and James (1996) find support for this effect for US firms and DeGryse and Ongena (1999) report supportive Norwegian evidence.

Slovin et al. (1992) investigate whether share price responses to loan announcements differ between large and small firms. Since large firms are well monitored and have acquired reputation, banks have less comparative advantage in the external financing process relative to the capital markets. On the other hand, for small firms, moral hazard and adverse selection problems are more severe, because they have shorter corporate histories, lesser reputations, and less public information is available for investors. Hence, small firms receive greater benefit from a bank’s screening and monitoring services. This result is confirmed by Wansley et al. (1993).

In addition to firm size, loan maturity has an impact on the expected magnitude of the announcement abnormal return. James (1987) points out that bank loans are typically of shorter maturities than other types of borrowings and this allows banks to exercise greater monitoring power and control over the borrower. Rajan (1992) makes a similar argument. Taken together, their work suggests that shorter maturity bank loans should be associated with more positive announcement effects than longer maturity bank loans.

In another study, Billett et al. (1995) investigate whether the lender’s identity influences the market reaction to a loan announcement. They find that higher quality lenders are associated with higher abnormal returns for the borrower. In a related study, Thakor (1996) shows that loans from lenders who face more binding capital constraints are associated with greater announcement effects in the borrower’s stock price. Since banks with capital constraints tend to ration credit more severely, equity markets react more positively when such banks grant loans.

Finally, Preece and Mullineaux (1996) highlight two additional aspects of bank loans: contractual flexibility and syndicate size. They argue that the capacity to renegotiate a bank loan relatively inexpensively in a corporate restructuring should complement monitoring as a source of value to borrowers.  

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1 Gilson and Warner (1998) show that, for certain firms, replacing bank debt with junk bonds can enhance financial flexibility.
It follows that, as the number of lenders in a syndicate increases, contracting costs rise and the capacity to renegotiate declines. Further, syndicated loans have less contractual flexibility compared to non-syndicated loans because of potential hold-out problems in the event of renegotiation. They hypothesize a negative relationship between abnormal returns and syndicate size and find support in empirical testing.\(^2\)

Table 1 summarizes our discussion of prior research results on loan announcement effects. The present note advances on prior work by testing all the effects in Table 1 on a common data base obtained outside the US. Compared to US banks, Canada’s Big Six banks, which dominate its banking system, are more homogeneous in size and credit rating. Because these banks are widely regarded as too big to fail, loans from a single Canadian bank have higher lender quality than syndicated loans involving a range of banks. Further, the trend toward securitization of credit is less advanced in Canada making it more common for firms of all sizes to borrow from banks. As a result, Canadian data

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\(^2\) Another important study of syndication is Dennis and Mullineaux (1997).
provide an ideal opportunity to test for the impact of firm size on loan announcement effects.

3. Sample selection and methodology

3.1. Sample selection

We obtained our sample of corporate loan announcements primarily by searching two wire services: Canadian Corporate News and Canada Newswire. These wire services are a primary news source for newspapers. For completeness, we also searched the Financial Post Database. Following the method employed by Billett et al. (1995), we searched using key words related to “credit” and “loans” and obtained a total of 4294 stories. First, we eliminated 2658 stories that were about personal and government loans. Then, we excluded 642 stories that contained “contaminated information” such as announcements of dividends, earnings, corporate control events, other types of financing arrangements, and credit rating changes. Moreover, another 558 firms were eliminated because they were not publicly traded. Since our study only considers firms that are traded on the Toronto Stock Exchange, we had to exclude 41 firms listed only on other exchanges. At this point, we compared the observations from the three sources and we eliminated 234 redundant observations. Our sample of “clean” announcements included 161 observations. Finally, 24 firms were omitted from the sample because they had missing observations. We finally include 137 observations drawn from 14 industries for the period 1988–1995.

Our classification of loan announcements follows Lummer and McConnell (1989) and Best and Zhang (1993) but we expand the scope of our sample in two ways. First, we include debt restructurings as an additional subsample in the bank loans category. Second, we add perspective by testing non-bank loans in the form of private placements issued by non-bank financial institutions, mainly insurance companies. We divide the bank loans into three main categories: new loans, renewals, and restructurings. A loan negotiation is considered to be new if the agreement is new or there is no indication that it is a renewal or restructuring. Based on the newspaper articles, we classify the new loans into three categories: new loans with new banks, new loans with the same bank, and new loans with unknown banks.

Renewals were also subdivided into three categories: Favorable, unfavorable, and mixed. As in Lummer and McConnell (1989) each renewal was

3 See Mackinlay (1997) and Maynes and Rumsey (1993) for discussion of thin trading bias in event studies.
assessed based on changes in loan maturity, interest rate, dollar value, and protective covenants. In a favorable renewal, the maturity of the loan is lengthened, the interest rate reduced, the dollar value of the loan increased, or the protective covenants are made less restrictive. A renewal is rated as unfavorable if one or more of the loan terms moves in the opposite direction. Finally, a renewal is considered as mixed if some terms are revised favorably and others are revised unfavorably.

The third category, restructurings, consists of loan revisions for borrowers known to be in financial distress. The sample of restructured loans includes two categories: (i) loans with prior negative news about the borrowing firm, and (ii) with no prior negative news.

While this detailed breakdown of our sample provides a rich menu of borrower and lender characteristics for testing, it does exact a toll in terms of reduced sample sizes in some of the categories. The overall sample is small relative to US studies reflecting the lesser size of Canada’s equity market and this reinforces the need to avoid drawing unwarranted inferences from small samples. To this purpose, we ensure that the critical values in the standard $t$-tests employed are adjusted upward appropriately for small samples under 30 cases. Further, recognizing that small samples are unlikely to be distributed normally, we verify our results using the non-parametric Wilcoxon ranked sign test. Finally, we recognize that many readers, accustomed to large samples in US studies, may wish to exercise greater caution in drawing inferences and we highlight sample sizes in going through our results.

3.2. Data and methodology

The Canadian Financial Markets Research Center (CFMRC) database includes daily opening and closing data for: prices, bids, asks, trades, and volumes for companies listed on the Toronto Stock Exchange. The daily returns in the CFMRC database are calculated as if the security were purchased at the close of day $t - 1$ and sold at the close of day $t$. The CFMRC value-weighted index is the market-value weighted, average daily return for all domestic equities in the database.

The market model is used to calculate excess returns. The two-day event window $[0, 1]$ is defined as the day of the announcement ($t = 0$) and the following day ($t = 1$). This procedure incorporates the possibility that some of the announcements are made after trading hours. The market model is estimated on daily returns for the period beginning 180 trading days before the event date and ending 31 trading days before the event date. The excess stock return, or prediction error, for firm $j$ over day $t$ is defined as

$$PE_{jt} = R_{jt} - (\hat{a}_j + \hat{\beta}_j R_{mt}),$$
where \( R_{jt} \) is the rate of return of security \( j \) over period \( t \), \( R_{mt} \) the rate of return on a value-weighted market index over period \( t \), \( \hat{\alpha}_j \) and \( \hat{\beta}_j \) the ordinary least squares estimates of firm \( j \)'s market model parameters.

Announcement period excess returns are calculated by summing the prediction errors for days 0 and 1 and then averaged over all firms within a particular group. Since tests of statistical significance are based on standardized prediction errors, we standardize the prediction errors for the two days dividing by the standard error of the forecast:

\[
SPE_j = \frac{\sum_{t=0}^{1} PE_{jt}}{S_j},
\]

where

\[
S_j = \left[ 2v_j^2 \left( 1 + \frac{1}{M} + \frac{(R_{mt} - R_m)^2}{\sum_{i=1}^{M}(R_{mi} - R_m)^2} \right) \right]^{1/2},
\]

\( v_j^2 \) is the residual variance of the market model regression for firm \( j \), \( M \) the number of days in the estimation period (i.e., \( M = 150 \)), \( R_{mt} \) is the market return in the event period and \( \overline{R}_m \) is the mean market return over the estimation period.

The average standardized prediction error is

\[
\overline{SPE}_t = \frac{1}{N} \sum_{j=1}^{N} SPE_{jt}.
\]

Finally, assuming that the individual prediction errors are cross-sectionally independent, the following \( t \)-statistic is calculated:

\[
t = \sqrt{N}(\overline{SPE}_t).
\]

Under the null hypothesis of no announcement effect, the standardized prediction errors (SPEs) are distributed asymptotically \( N(0, 1) \) and the mean standardized prediction error is distributed \( N(0, 1/\sqrt{N}) \):

\[
H_0 : \overline{SPE}_t = 0.
\]

4. Empirical results

Table 2 reports full sample results of the average stock price response to loan announcements. The average excess return for all bank loans is 1.22%, a result statistically significant at the 0.01 level based on a sample of 122 cases. In addition, 68% of the excess returns are positive. On the other hand, the average excess return for the private placements is not statistically significant with
Table 2
Average announcement-period excess returns, significance tests, and proportion of positive excess returns for a sample of 122 bank loans and 15 private placements for TSE-listed companies, 1988–1995

<table>
<thead>
<tr>
<th>Type of announcement</th>
<th>Sample size</th>
<th>Average excess return</th>
<th>t-Statistic</th>
<th>$Z$ non-parametric [p-Value]</th>
<th>Proportion positive</th>
</tr>
</thead>
<tbody>
<tr>
<td>(I) All loans</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Bank loans</td>
<td>122</td>
<td>1.2256%</td>
<td>5.62**</td>
<td>-2.79** [0.0052]</td>
<td>0.68</td>
</tr>
<tr>
<td>Private placements</td>
<td>15</td>
<td>-0.0042%</td>
<td>-0.64</td>
<td>-0.1704 [0.8647]</td>
<td>0.46</td>
</tr>
<tr>
<td>(II) Bank loans</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>New loans</td>
<td>69</td>
<td>0.6225%</td>
<td>2.78**</td>
<td>-2.02** [0.0054]</td>
<td>0.59</td>
</tr>
<tr>
<td>Renewals</td>
<td>35</td>
<td>1.2678%</td>
<td>3.52**</td>
<td>-2.14** [0.0319]</td>
<td>0.71</td>
</tr>
<tr>
<td>Restructurings</td>
<td>18</td>
<td>3.4556%</td>
<td>4.28**</td>
<td>-3.46** [0.0005]</td>
<td>0.94</td>
</tr>
<tr>
<td>(III) New loans</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>New loans with new bank</td>
<td>20</td>
<td>-0.2483%</td>
<td>-0.47</td>
<td>-0.53 [0.5931]</td>
<td>0.58</td>
</tr>
<tr>
<td>New loans with same bank</td>
<td>31</td>
<td>1.0879%</td>
<td>3.36**</td>
<td>-2.05** [0.0439]</td>
<td>0.61</td>
</tr>
<tr>
<td>New loans with unknown bank</td>
<td>18</td>
<td>0.7886%</td>
<td>1.53</td>
<td>-1.24 [0.2541]</td>
<td>0.55</td>
</tr>
<tr>
<td>(IV) Renewals</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Favorable</td>
<td>20</td>
<td>1.7307%</td>
<td>3.98**</td>
<td>-2.27** [0.0228]</td>
<td>0.85</td>
</tr>
<tr>
<td>Mixed</td>
<td>11</td>
<td>1.7891%</td>
<td>2.04*</td>
<td>-1.55 [0.2477]</td>
<td>0.63</td>
</tr>
<tr>
<td>Unfavorable</td>
<td>4</td>
<td>-2.4805%</td>
<td>-2.20</td>
<td>-1.46 [0.1441]</td>
<td>0.25</td>
</tr>
<tr>
<td>(V) Restructurings</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>With no prior negative news</td>
<td>8</td>
<td>2.9089%</td>
<td>2.75**</td>
<td>-2.00** [0.0043]</td>
<td>0.88</td>
</tr>
<tr>
<td>With prior negative news</td>
<td>10</td>
<td>3.8930%</td>
<td>3.28**</td>
<td>-2.24** [0.0087]</td>
<td>1.00</td>
</tr>
</tbody>
</table>

* Significant at the 0.10 level.
** Significant at the 0.05 level.
*** Significant at the 0.01 level.
only 15 cases. This result is consistent with the hypothesis that banks have a comparative advantage over other lenders. When different categories of bank loans are considered, we find that the average excess returns for new loans and renewals are 0.62% and 1.26%, respectively, both significant at the 0.01 level. The mean excess returns for restructurings of 3.45 % is also highly significant but the sample is small at 18 cases.

These results are again consistent with our hypotheses, except for the new loans, for which we predicted insignificant abnormal returns. In many cases, the new loan is arranged with a bank that has prior financing experience with the borrowing firm, signaling some degree of monitoring capacity. With a closer look at new loans, we find that new loans with the same bank carry an average excess return of 1.08% which is statistically significant at the 0.01 level for a sample size of 31 cases. New loans with new or unknown banks comprise smaller samples and do not show significance.

In the renewals category, we are able to distinguish three types but the sample sizes are quite small. Favorable renewals show an average excess return of 1.73% statistically significant at the 0.01 level. The unfavorable renewals display an average excess return of −2.48% which is not statistically significant. Both of these results are consistent with our prior hypothesis. In contrast, mixed renewals show an average excess return of 1.78% achieving marginal statistical significance at the 10% level. This contradicts our hypothesis predicting a less positive signal from mixed loan renewals than from favorable ones. Lummer and McConnell (1989) report a similar result. This anomalous result could rise from the way we assessed mixed revisions giving equal weights to favorable and unfavorable terms. It is possible that some loan terms outweigh others giving rise to misclassifications.

Finally, in the case of restructurings, as for renewals, we are forced to work with small numbers. The average abnormal return for restructurings with no prior negative news is 2.90%, statistically significant at the 0.05 level. The average excess returns for cases with prior negative news is 3.89%, and significant at the 0.01 level. These results are also supportive of our hypothesis that the announcement effect should be stronger when the market is already aware of the borrower’s financial distress.

In order to confirm the robustness of our parametric tests, we perform Wilcoxon ranked sign tests. The null hypothesis with this test remains unchanged and the corresponding test statistic is

\[ z = \frac{T_+ - \mu_{T_+}}{\sigma_{T_+}}, \]

where \( T_+ \) is the sum of the ranks for positive abnormal returns. If the abnormal returns are centered at 0, i.e., \( H_0 \) is true, then \( T_+ \) is approximately a normal random variable with mean and standard deviation (Kvanli et al., 1992):
Table 2 shows that the results of the non-parametric test confirm our results from the parametric tests, only at a weaker significance level. This finding suggests that no serious bias was introduced by the assumption of normality underlying the \( t \)-tests.

5. Regression analysis

Pooling all our observations, we estimate a multivariate regression for the 122 bank loans with the two-day, announcement period, standardized excess return as the dependent variable. The regression analysis has the potential to validate the other tests already discussed in several important ways. First, by employing dummy variables to classify the observations, we are able to use the entire sample and avoid difficulties associated with small samples. Second, as a joint test on all the major variables studied, the regression allows us to measure the robustness of individual tests conducted variable by variable. In particular, robustness tests allow us to address possible overlaps between our variables.

The independent variables are:

\( X_1, X_2, X_3, X_4, \) and \( X_5 \): Five dummy variables indicating whether (i) the loan is a new loan, (ii) the loan is with the same bank, (iii) the loan is a new loan and with the same bank, (iv) the loan is a favorable renewal, and (v) the loan is a restructuring.

\( X_6, X_7, \) and \( X_8 \): Three dummy variables indicating whether (i) the loan is syndicated, (ii) the corporate rating of the borrowing firm is BBB and above, and (iii) the loan has medium to long term maturity.

\( X_9 \): A continuous variable that shows the relative size of the loan and defined as the value of the loan divided by the market value of the firm.

The regression results are in Table 3. The first five dummies test whether the loan type has a significant impact on excess returns. The table shows that excess returns are significantly higher when the loan is negotiated with the same bank, whether it is a new loan or a renewal. This supports the importance of delegated monitoring. Additionally, the significance of dummy 3 suggests that, in this sample, firms are not switching banks to avoid rents. The positive and significant sign for the restructuring dummy \( (X_5) \) confirms the strength of this signal of bank confidence.

The next three variables are dummies testing the signs of the impact of lender (syndicate), borrower (rating), and loan (maturity) characteristics. As seen in Table 3, syndication \( (X_6) \) is associated with lower excess returns. This confirms the argument by Preece and Mullineaux (1996) that the contractual flexibility that exists with a single lender is reflected in the equity market’s...
reaction to the announcement of the loan. Moreover, since most of the non-

syndicated loans in our sample are issued by Canada’s Big Six banks, our re-

sults suggest that loans issued by a single Canadian bank have higher lender

quality than syndicated ones.

The significant negative coefficient for credit rating ($X_7$) is consistent with

Diamond (1991) who suggests that low-rated firms benefit more from a bank’s

monitoring service do than high-rated firms. One reason is that low-rated firms

are more likely to benefit from risk reduction inherent in collateral and cove-
nants (Rajan and Winton, 1995; Mazumdar and Yan, 1997). Further, low-rated

firms likely benefit more from the financial flexibility of bank loans according to


The long-term maturity dummy ($X_8$) also carries a negative coefficient. This

supports the theoretical argument of James (1987) who emphasizes that shorter

maturities lead to more frequent renewals increasing banks’ monitoring pow-

ers. With shorter maturities assigned to more risky borrowers, we would expect

greater announcement period excess returns for short-term loans.

<table>
<thead>
<tr>
<th>Variable</th>
<th>Coefficient</th>
<th>t-Statistic</th>
</tr>
</thead>
<tbody>
<tr>
<td>$X_1$ (1 if new loan, 0 otherwise)</td>
<td>0.05</td>
<td>0.67</td>
</tr>
<tr>
<td>$X_2$ (1 if same bank, 0 otherwise)</td>
<td>0.36</td>
<td>3.02***</td>
</tr>
<tr>
<td>$X_3$ (1 if new loan and same bank, 0 otherwise)</td>
<td>0.08</td>
<td>2.21**</td>
</tr>
<tr>
<td>$X_4$ (1 if a renewal loan, 0 otherwise)</td>
<td>0.39</td>
<td>3.46***</td>
</tr>
<tr>
<td>$X_5$ (1 if a restructuring loan, 0 otherwise)</td>
<td>0.59</td>
<td>3.65***</td>
</tr>
<tr>
<td>$X_6$ (1 if syndicated, 0 if non-syndicated or unknown syndication)</td>
<td>-0.3128</td>
<td>-1.98**</td>
</tr>
<tr>
<td>$X_7$ (1 if firm has BBB rating and above, 0 if below BBB rating and non-rated)</td>
<td>-0.2642</td>
<td>-1.87*</td>
</tr>
<tr>
<td>$X_8$ (1 if medium-term and long-term maturity, 0 if short term or unknown maturity)</td>
<td>-0.2966</td>
<td>-2.04**</td>
</tr>
<tr>
<td>Relative size (loan size/MV of firm)</td>
<td>-0.3871</td>
<td>-1.76*</td>
</tr>
<tr>
<td>Intercept</td>
<td>-0.51</td>
<td></td>
</tr>
<tr>
<td>R-squared</td>
<td>0.36</td>
<td></td>
</tr>
</tbody>
</table>

* Significant at the 0.10 level.
** Significant at the 0.05 level.
*** Significant at the 0.01 level.
The final dummy ($X_9$) is a continuous, ratio measure of size. As predicted, larger loans are associated with smaller excess returns. Our results confirm findings of Slovin et al. (1992) that primarily small and less prestigious firms receive the greatest benefit from the screening and monitoring services provided by banks.

6. Conclusions

This paper validates the key results of prior studies of bank loan announcements effects using a common data set drawn from the Canadian capital market. We find that announcements of bank loans are associated with positive abnormal returns and that these are significantly higher than found for announcements of private placements. Also consistent with prior research is our finding that syndication weakens the announcement effect because it diminishes a key advantage of bank borrowing: the flexibility to renegotiate loan terms.

For bank loans, the announcement effect is heightened when monitoring is most intense. Renewals of loans and new loans to existing customers are both cases in which the bank is likely to have in-depth private information about the borrower. As a result, these trigger more positive announcement effects than do new loans in general.

Beyond the intensity of monitoring, the market reacts strongly when an announcement signals that the bank’s private information is favorable. This occurs when the terms of the loan revision are made more favorable through relaxation of covenants or extending maturity. Alternatively, a bank can send a positive signal by announcing a loan to a weaker credit. Credit weakness is evidenced when a borrower falls into the restructuring or the small firm categories. It is also associated with a lower credit rating or shorter loan maturity.

Taken together, these results suggest that the conclusions of prior studies on bank loan announcements, conducted exclusively on US data, are robust for a different banking system.

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