

On the Non-Exclusivity of Loan Contracts: An Empirical Investigation

Hans Degryse

KU Leuven, Tilburg University and CEPR

Vasso Ioannidou

Tilburg University

Erik von Schedvin

Tilburg University & Sveriges Riksbank

**HIT-TDB-RIETI International Workshop on the “Economics of
Interfirm Networks”**

November, 2012

General Introduction

- Banks are very important providers of external finance
 - Other sources
 - Capital market financing
 - Trade financing
- Banks are very important in particular to small and medium sized firms
- Why banks? What is different from arm's length financing or trade financing?
 - banks are specialists in resolving asymmetric information problems
 - screening
 - monitoring

General Introduction

- Relationship banking: bank learns by lending and interacting with firm over time and across products (e.g., checking account information (Mester, Nakamura and Renault (2007), or Norden and Weber (2010))
 - Benefits of relationship banking
 - For banks: extract rents and differentiate themselves from other banks
 - Kim, Kliger and Vale (2003): 16 percent of customer’s value-added stems from lock in
 - For firms: credit availability / flexibility, control, and confidentiality embedded in bank relationship
 - What in crisis times? Supply induced effects from banks
 - » strong relationships help in mitigating supply effects (e.g., Puri, Rocholl and Steffen (2011))
 - Costs of relationship banking
 - For banks: relationship investments are sunk and may lead to “debt overhang” behavior
 - For firms: gives the relationship bank a competitive edge over other financiers
 - Ioannidou and Ongena (2010): switchers pay 80 bp lower rates than similar non-switching firms

General Introduction

- In the remainder of the talk we highlight an additional benefit and cost from moving from single to multiple relationship banking (non-exclusivity)
 - Multiple relationships may increase a firm's debt capacity
 - However, it also leads to reduced credit availability at the initial bank stemming from negative contractual externalities
 - Except when the existing and *future* loans at the initial bank **are protected** from the increased risk

Motivation

- Financial contracts are often **non-exclusive**
 - borrowers cannot commit to borrow from at most **one lender**
 - contracts cannot be made fully **contingent** on other lenders
 - E.g., on future lenders
- Non-exclusivity → **negative externalities**
 - Moral Hazard (e.g., Bizer and DeMarzo, JPE 1992, Holmström and Tirole , QJE 1997)
 - Strategic Default (e.g., Parlour and Rajan, AER 2001)
- Non-exclusivity → Decrease the initial lender's **willingness to lend**
- Depending on the **institutional framework, contractual terms** could help mitigate the externalities from non-exclusivity
 - E.g., Fama and Miller (1972), Bizer and DeMarzo (JPE 1992), Bennardo, Pagano, and Piccolo (2009), Parlour and Rajan (AER 2001), Attar et al. (2010)

Motivation

- Despite the substantial theoretical work on the impact of non-exclusivity, there is **little empirical evidence**
- This is partly due to the **lack of adequate data...**
- A borrower's **outstanding debt** is an equilibrium outcome, driven both by **demand & supply** factors, whereas theory concerns supply effects
- **THIS PAPER** aims to fill this gap by employing a unique dataset containing information on a creditor's willingness to lend to a borrower both before and after a non-exclusivity event realizes

This paper

- We examine how a bank's willingness to lend to a previously exclusive borrower changes once the borrower obtains a loan from another bank
- ... in an **institutional setting** where banks:
 - Can learn quickly about loans from other banks – [**credit registry**]
 - Could use collateral effectively to protect their claims – [**collateral registry**]
 - E.g., Haselmann, Pistor, and Vig (RFS 2010)
- We also examine how the bank's response varies when its existing and *future* loans **are protected** from the increased risk
 - E.g., Seniority and valuable collateral

Hypotheses

The theory on contractual externalities predicts that:

- **H1.** *When a borrower takes an outside loan, the **initial bank's willingness to lend** to the borrower **decreases** in the size of the **outside loan**.*
- **H2.** *An outside loan will **not trigger a change** in the initial bank's willingness to lend if the initial bank's **existing and future loans are protected** from the increased risk.*

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Alternative Theories

Decrease probability of default

e.g., Detragiache et al. (JF 2000) & Hertzberg et al. (JF 2011)

Perceived as a positive signal

e.g., Biais and Gollier (RFS 1997)

Hypotheses/Findings

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Support

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Support

Support

Retain Seniority

Secured: assets with high value & low volatility

Data

- Detailed **contract characteristics** of all **commercial loans** from one of the largest **Swedish** banks from April 2002 to December 2008.
- Complemented with:
 - Accounting statements
 - Information from the main credit bureau
 - E.g., ratings, nonperformance with other creditors
 - Information from the Swedish registration office
 - E.g., collateral pledges

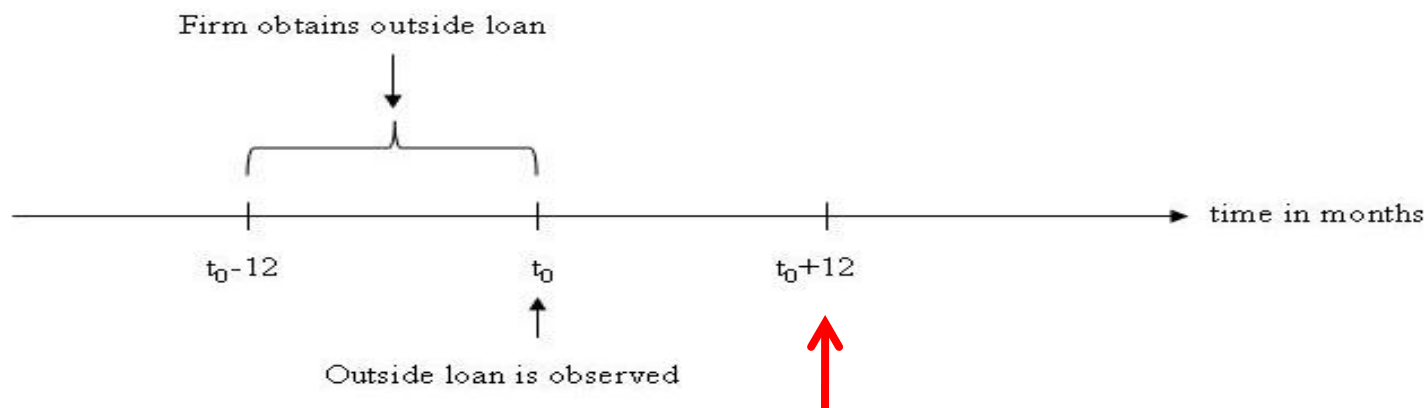
Key Variables

- **Internal Limit:** a measure of the bank's willingness to lend to a firm — indicates the amount for which the bank's loan supply becomes vertical
 - Determined based on the borrower's estimated **repayment capacity**
 - Internal proprietary info & external public info
 - During **annual “commitment review” meetings**
 - Timing predetermined but could be moved earlier (36%)
 - Not directly communicated to the borrower
 - Involves **no commitment**
- **Floating Charge/Lien:** a type of collateral that extends automatically to future loans =>
 - Existing bank's current and future loans **retain seniority** over outside loans
 - Loans are **secured by pledged assets**.
 - Value & Volatility

Methodology (1)

Treatment & Control Groups

- The **TREATMENT GROUP** consists of firms that enter the sample with an exclusive relationship with our bank (for at least one year) and at some point during the sample period take a loan from another bank:

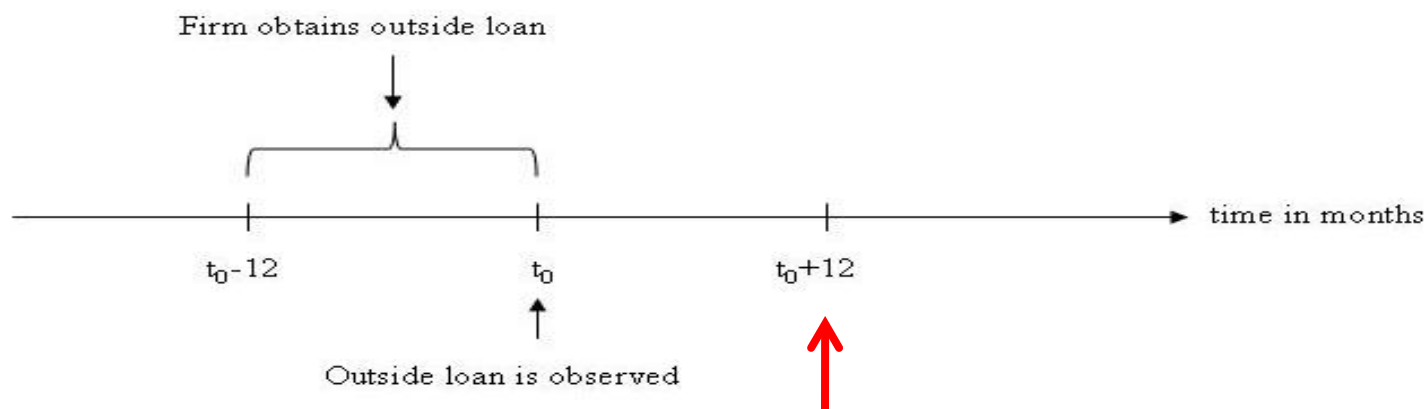


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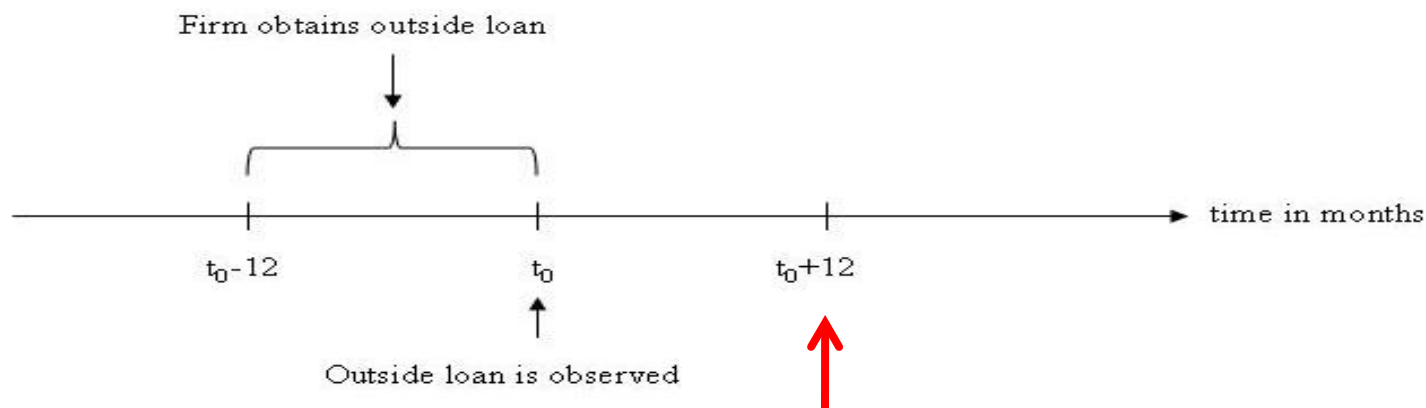
- The bank's response is benchmarked relative to a **CONTROL GROUP** of **SIMILAR FIRMS** that enter the sample with an exclusive relationship with our bank and maintain this exclusive relationship at least until t_0+12 .

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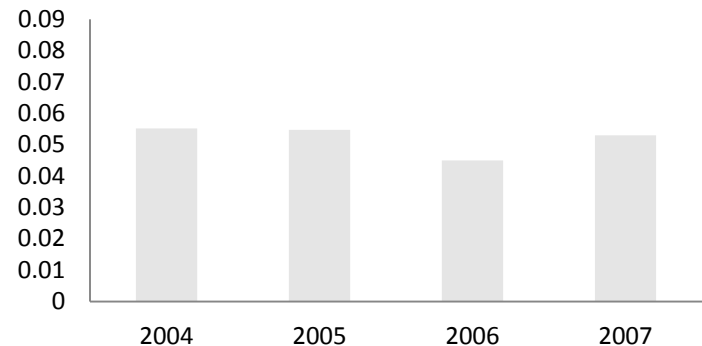


- The bank's response is benchmarked relative to a **CONTROL GROUP** of **SIMILAR FIRMS** that enter the sample with an exclusive relationship with our bank and maintain this exclusive relationship at least until t_0+12 .
- Our dependent variable becomes:

$$y = [(\text{Limit}_{t_0+12} - \text{Limit}_{t_0-12})/\text{Total Assets}_{t_0-12}]_{\text{treated}} - [(\text{Limit}_{t_0+12} - \text{Limit}_{t_0-12})/\text{Total Assets}_{t_0-12}]_{\text{control}}$$

Descriptive Statistics

- This yields 991 non-exclusivity events
- Incidence of non-exclusivity events each year: **stable & around 5%**



- **Comparable to other studies:** 4.5% in Ioannidou and Ongena (2010, JF) using data from Bolivia & 4% in Farinha and Santos (2002, JFI) using data from Portugal.

	Median
- <i>OutsideLoan</i> = Outside Loans to Total Assets	0.06
- Size of Outside Loan to internal limit	0.15

Methodology (2)

Treatment & Control Groups

We **MATCH** on:

Public

- Time (month-year)
- Industry (2 digit NACE codes)
- Firm Age
- Total Assets
- Total Asset's Growth
- Tangible Assets to Total Assets
- Cash Flows to Total Assets
- Total Debt to Total Assets
- Total Bank Debt to Total Assets
- External Rating (1-5)
- Recent Repayment problems

Private

- Internal limit
- Distance to limit (including unused credit lines)
- Interest rate (or internal rating)

Unobserved Heterogeneity

“Match 2”

Results: H1

Average Response & Size of the Outside Loan

Table 4: Non-Exclusivity Externalities and the Size of the Outside Loan: Test of H1

Dependent variable: $[(\text{Limit}_{t0+12}-\text{Limit}_{t0-12})/\text{TA}_{t0-12}]_{\text{Treated}} - [(\text{Limit}_{t0+12}-\text{Limit}_{t0-12})/\text{TA}_{t0-12}]_{\text{Control}}$		
	(III)	(IV)
	Match 2	Match 2
Number of Observations (Matched Pairs)	549	549
Number of Treated Firms	207	207
<i>Intercept</i>	-0.062*** (-2.877)	-0.014 (-0.559)
<i>OutsideLoan</i>		-0.408*** (-3.152)
R ²	-	0.060

- A bank's internal limit to total assets of a "treated" firm drops by **6.2 percentage points** more than the internal limit to total assets of similar "control" firms.
 - Mean/Median Limit-to-Total Assets around 40% => **15%** decrease

Results: H1

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- A bank's internal limit **drops more** the **larger the outside loan**
 - A **1\$** larger outside loan reduces the initial bank's limit by **41 cents**.

Results: H2

Floating Charge, Value, and Volatility

Dependent variable: $[(\text{Limit}_{t0+12}-\text{Limit}_{t0-12})/\text{TA}_{t0-12}]_{\text{Treated}} - [(\text{Limit}_{t0+12}-\text{Limit}_{t0-12})/\text{TA}_{t0-12}]_{\text{Control}}$		
	(V)	(VI)
	Match 2	Match 2
Number of Observations (Matched Pairs)	549	549
Number of Treated Firms	207	207
<i>Intercept</i>	-0.013 (-0.509)	-0.013 (-0.515)
<i>OutsideLoan</i>	-0.496*** (-4.359)	-0.496*** (-4.348)
<i>OutsideLoan x FloatingCharge</i>	0.515*** (3.614)	
<i>FloatingCharge</i>	0.053 (0.564)	
<i>OutsideLoan x FloatingChargeValue</i>		1.437*** (4.758)
<i>FloatingChargeValue</i>		-0.045 (-0.192)
<i>OutsideLoan x FloatingChargeVolatility</i>		-8.100* (-1.849)
<i>FloatingChargeVolatility</i>		1.203 (0.748)
R ²	0.08	0.09

- The firm's initial bank **does not react** to the *outside loan* if its claims are **protected with a floating charge** on the firm's assets.

Results: H2

Floating Charge, Value, and Volatility

Dependent variable: $[(\text{Limit}_{t0+12} - \text{Limit}_{t0-12}) / \text{TA}_{t0-12}]_{\text{Treated}} - [(\text{Limit}_{t0+12} - \text{Limit}_{t0-12}) / \text{TA}_{t0-12}]_{\text{Control}}$

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- The floating charge's effectiveness depends **positively** on the **value** of the pledged assets and **negatively** on the **volatility** of their values.

Results: H2

Other Collateral

Dependent variable: $[(\text{Limit}_{t0+12}-\text{Limit}_{t0-12})/\text{TA}_{t0-12}]_{\text{Treated}} - [(\text{Limit}_{t0+12}-\text{Limit}_{t0-12})/\text{TA}_{t0-12}]_{\text{Control}}$		
	(VII)	(VIII)
	Match 2	Match 2
Number of Observations (Matched Pairs)	549	549
Number of Treated Firms	207	207
<i>Intercept</i>	-0.011 (-0.395)	-0.011 (-0.373)
<i>OutsideLoan</i>	-0.377** (-2.569)	-0.482*** (-3.584)
<i>OutsideLoan x FloatingCharge</i>		0.500*** (3.137)
<i>FloatingCharge</i>		0.051 (0.537)
<i>OutsideLoan x OtherCollateral</i>	-0.007 (-0.140)	-0.007 (-0.145)
<i>OtherCollateral</i>	-0.168 (-0.774)	-0.064 (-0.306)
R ²	0.06	0.08

- **Other collateral** does **not mitigate** the negative externalities: the initial bank reduces its willingness to lend in a similar way as uncollateralized loans

Additional Findings

- Results are driven by non-exclusivity events where the outside loan brings the firm **above the initial bank's limit**
 - i.e., $\text{outstanding debt} + \text{outside loan} > \text{internal limit}$

Robustness (1)

- Results are robust to **additional matching**:
 - Require that between t_0-12 and t_0 the control firm got an inside loan of similar size to the treated firm's outside loan
 - Relationship length
 - Floating Charge

Robustness (2)

- Findings are **not driven** by the following **alternative explanations**:
 - Reduced possibilities for rent extraction
 - Fixed fees on lending products, market power, firm size and age
 - Anticipation of non-exclusivity event
 - Earlier period i.e., t_0-24 and t_0-12
 - Endogeneity
 - Next page...

Robustness (3)

ENDOGENEITY

- **Reverse Causality**
 - A prior (and gradual) reduction in the limit pushed the firm elsewhere
 - Failure to increase the limit and accommodate the growing needs of the firm gave incentives to look for an outside loan
- **Omitted Variable Bias**
 - Private information about deteriorating future performance may give incentives to secure additional credit before their bank and other potential creditors learn this => decrease in limit we observe could be due to news about their deteriorating performance

Summary

- Findings are consistent with the theories on contractual externalities
- When a previously exclusive firm obtains an outside loan, the firm's initial bank **decreases** its internal limit to the firm and it decreases it more the larger the **outside loan**
- The initial bank's willingness to lend does **not change** when its existing and future loans are protected from the increased risk:
- when its existing and future loans **retain seniority** over the outside loans & loans are secured with assets whose **value is high** and **stable** over time

So the bottom line is...

- Information on counterparty exposures combined with the effective use of general collateral could help creditors mitigate non-exclusivity externalities

Additional Questions

(currently working on)

- What happens to the firm's borrowing costs?
- What happens to the firm's probability of default? At the initial bank? At the new bank?
- How does the likelihood of a non-exclusivity event affect the initial bank's willingness to lend to start with...
- ... and how does this relate with subsequent adjustments once the event takes place...

Descriptives: Floating Charge

Variable Names	Floating Charge			No Floating Charge		
	Mean	Median	SD	Mean	Median	SD
Firm Characteristics						
<i>Public</i>						
Firm Age	12.938	11.500	8.858	21.948	17.000	14.193
Total Assets	11,800,000	2,582,500	21,800,000	10,300,000	2,895,000	33,600,000
Asset Growth	0.968	0.998	0.180	1.076	1.037	0.222
Tangible Assets to Total Assets	0.771	0.804	0.223	0.817	0.870	0.169
Cash Flow to Total Assets	0.028	0.040	0.080	0.053	0.051	0.069
Total Debt to Total Assets	0.518	0.510	0.209	0.506	0.498	0.206
Total Bank Debt to Total Assets	0.322	0.211	0.268	0.337	0.317	0.219
Probability of Default	1.881	1.850	1.442	1.811	1.200	2.409
External Rating (1-5, 5 best)	3.188	3.000	0.911	3.288	3.000	0.831
Recent Repayment Problems	0.000	0.000	0.000	0.000	0.000	0.000
<i>Private</i>						
Internal Limit	6,021,424	924,639	11,700,000	5,593,614	1,294,000	19,900,000
Internal Limit to Total Assets	0.488	0.400	0.296	0.447	0.429	0.191
Distance to Limit	0.118	0.033	0.129	0.085	0.039	0.102
Loan Interest Rate (%)	6.090	5.970	1.835	6.650	6.650	1.587
Internal Rating (1-5, 5 best)	3.333	3.000	0.866	3.079	3.000	0.754
Outside Loan & Limit Adjustment						
Outside Loan to Total Assets	0.133	0.046	0.316	0.126	0.046	0.266
Outside Loan to Internal Limit	0.268	0.104	0.440	0.330	0.104	0.837
Adjustment in the Internal Limit	-0.031	-0.010	0.525	-0.094	-0.067	0.542

Robustness: Reverse Causality?

Table 5: Robustness Checks: Alternative Explanations and Additional Controls

	(I)	(II)	(III)	(IV)	(V)	(VI)	(VII)	(VIII)	(IX)	(X)
	Match 2	Match 2	Match 2	Match 2	Match 2	Match 2	Match 2	Match 2	Match 2	Match 2
Number of Observations (Matched Pairs)	344	344	339	339	549	549	46	46	201	201
Number of Treated Firms	132	132	154	154	207	207	38	38	122	122
<i>Intercept</i>	0.002 (0.226)	0.008 (0.763)	-0.069*** (-3.316)	-0.007 (-0.351)	-0.063*** (-2.907)	-0.014 (-0.587)	-0.089* (-1.854)	0.084 (1.560)	-0.068* (-1.958)	-0.007 (-0.181)
<i>OutsideLoan</i>		-0.046 (-1.105)		-0.610*** (-6.471)		-0.403*** (-3.079)		-1.719*** (-3.572)		-0.435*** (-2.870)
<i>Fees to Total Assets</i>					0.020 (1.149)	0.005 (0.281)				
R ²	-	0.01	-	0.12	0.00	0.06	-	0.27	-	0.07

Robustness: omitted variable bias?

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Robustness: reduced rent extraction?

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Robustness: matching on additional characteristics

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