Study reveals implications of the incentive to coordinate among bank lenders

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Columbia Business School study shows that a bank reacts more to the same piece of news if it knows that other banks have the same information and hence will be reacting to the news as well.

When a firm experiences a negative shock – e.g. a drop in revenues, loss of the CEO – it will face difficulties when raising new debt for many reasons. The most obvious reason for this difficulty is that the fundamentals of the firm are weaker and lenders recognize that there is less chance the firm can generate the necessary cash flows to repay the loan. Another primary reason is that a lender may worry that the bad news will scare off other creditors and will drive the firm into bankruptcy. This leads to the possibility of inefficient "creditor runs" whereby bank A ceases lending to the company because it anticipates that bank B will do so and vice versa. A study conducted by Columbia Business School Professor Daniel Paravisini, Gary Winnick and Martin Granoff Associate Professor of Business, Finance and Economics, further reveals this process and finds that lenders to distressed firms have strong incentives to coordinate their actions. Paravisini and his coauthors, Andrew Hertzberg, Assistant Professor, Finance and Economics at Columbia Business School, and José María Liberti, Associate Professor of Finance at Tilburg University and Assistant Professor of Finance at Kellstadt Graduate School of Business, DePaul University, show that a bank reacts more to the same piece of news if it knows that other banks have the same information and hence will be reacting to the news as well. The study is part of Professor Paravisini's body of research that investigates the determinants of banks' willingness to issue loans and was recently featured in the *Journal of Finance*.

The research also depicts how the outcome of coordination is inefficient, as if both banks lent, the firm would remain solvent and be able to service both debts. This phenomenon is one of the reasons why the modern bankruptcy code is designed to facilitate negotiation among creditors in order to alleviate creditor coordination problems when firms are in financial distress. Furthermore, while this lender coordination has great economic importance, to date there has been little evidence that measures the implications of lender coordination and firm indebtedness. One reason for the previous lack of evidence is that while we often see credit reductions to firms who experience negative shocks, it is not clear how much of the reductions is a reaction to fundamentals versus an additional reaction to the anticipated response of other creditors.

To isolate the incentive to coordinate amongst lenders, the researchers look at the expansion of the Public Credit Registry in Argentina in 1998. Public credit registries are government-managed databases of borrowers' credit information in a financial system. Akin to a credit scoring system for personal borrowers in the U.S., the purpose of a registry is to share among lenders information about the financial position of corporations – how much do they borrow, how timely are their repayments. Argentina's registry underwent a unique reform in 1998: the credit information of corporations with total debt below $200,000, whose information was previously not disclosed, became public. Since the reform was announced in April, enacted in July, and retroactive to January, the researchers were able to identify three relevant periods in the registry data: 1) a pre-announcement period, when banks reported information to the Central Bank under the presumption it would remain private, 2) an interim period after the reform announcement in April 1998 and before its implementation in July of the same year, during which lenders knew information they reported in the pre-expansion period would become public, but they had not yet received other lenders' information, and 3) a post-expansion period, when banks make lending and reporting decisions having observed the previous reports of other banks.

The researchers focus on banks that had bad news about a borrower prior to the announcement of the registry expansion. They show that these lenders significantly decreased lending during the interim period when they learned that this news would soon be shared with other lenders. This response cannot be explained by a reaction to fundamentals since the bank had not yet learned anything new about the firm in question and thus must be an anticipated response to the effect that the news would have on the firm's other sources of credit. The magnitude of the lending decline was substantial: during the interim period the registry expansion announcement caused a 19.8 percent decline in a firm's debt with lenders that had rated it a poor risk in the pre-announcement period. The researchers also show that the decline in lending during the interim period causes financial distress: over one in every twenty firms with a poor rating in the pre-announcement period defaulted on their debt as a consequence of the announcement that their credit information would become public. In line with their predictions, the authors also show that when the bad news is finally received by the firm's other creditors that they do in fact withdraw credit. A key observation that highlights the role of lender coordination is that the registry expansion announcement had no effect on firm debt or default for those corporations that obtained all their credit from a single bank.

The results highlight that the incentive to coordinate amongst creditors to borrowers who are close to distress can be strong and suggest that the possibility of inefficient credit reductions which are due to the collective freezing of all creditors may be important. This has several important policy implications. It suggests that fostering negotiation amongst creditors may be important to avoid inefficient break downs of collective actions amongst lenders. The study also highlights a downside to making credit information shared – the effect of a shock to a firm creditworthiness can be exacerbated.

Provided by Columbia Business School

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