Taking No Chances: Lender Monitoring and Corporate Acquisitions

Luca X. Lin

IESE Business School, University of Navarra

December 2020

Motivation

IESE Business School University of Navarra

- Relative lack of empirical evidence on lender monitoring despite an extensive theoretical discussion (Shleifer and Vishny,1997;Nini et al.,2012)
- Existing empirical studies on creditor governance focus on the loan covenant setting (Nini et al.,2009,2012;Denis and Wang,2014;Ferreira et al.,2018)

Motivation

IESE Business School University of Navarra

- Relative lack of empirical evidence on lender monitoring despite an extensive theoretical discussion (Shleifer and Vishny,1997;Nini et al.,2012)
- Existing empirical studies on creditor governance focus on the loan covenant setting (Nini et al.,2009,2012;Denis and Wang,2014;Ferreira et al.,2018)
- Beyond contractual provisions, lenders monitor regularly to stay informed and make efficient resolution decisions (e.g.Diamond,1984,1991;Fama,1985;Rajan and Winton,1995)
- Evidence of active **non-covenant-based monitoring** (Gustafson et al.,2020) - borrower meetings, site visits, demanding information on a monthly, even daily basis

Motivation

IESE Business School University of Navarra

- Relative lack of empirical evidence on lender monitoring despite an extensive theoretical discussion (Shleifer and Vishny,1997;Nini et al.,2012)
- Existing empirical studies on creditor governance focus on the loan covenant setting (Nini et al.,2009,2012;Denis and Wang,2014;Ferreira et al.,2018)
- Beyond contractual provisions, lenders monitor regularly to stay informed and make efficient resolution decisions (e.g.Diamond,1984,1991;Fama,1985;Rajan and Winton,1995)
- Evidence of active **non-covenant-based monitoring** (Gustafson et al.,2020) - borrower meetings, site visits, demanding information on a monthly, even daily basis
- Strong positive association with lead lender's "skin in the game"

What This Paper Does

IESE Business School University of Navarra

Does lender monitoring only serve as information acquisition, or does it also have real effects on firm behavior?

What This Paper Does

IESE Business School University of Navarra

Does lender monitoring only serve as information acquisition, or does it also have real effects on firm behavior?

- Difference-in-difference design based on lender mergers (Chu,2019) - banks are unlikely to merge based on factors related to a few particular firms
- Bank mergers are mainly driven by regulatory changes, development in information technology, business strategy reasons such as market penetration (Harford,2005;Jayaraman et al.,2002)

What This Paper Does

IESE Business School University of Navarra

Does lender monitoring only serve as information acquisition, or does it also have real effects on firm behavior?

- Difference-in-difference design based on lender mergers (Chu,2019) - banks are unlikely to merge based on factors related to a few particular firms
- Bank mergers are mainly driven by regulatory changes, development in information technology, business strategy reasons such as market penetration (Harford,2005;Jayaraman et al.,2002)
- Lender merger $\uparrow$ skin in the game$\rightarrow$increased incentive to monitor (Sufi,2007;Ivashina,2009)
- A more concentrated loan stake $\downarrow$ coordination problem with other lenders$\rightarrow\uparrow$bargaining power when renegotiating with the manager (Chu,2019)

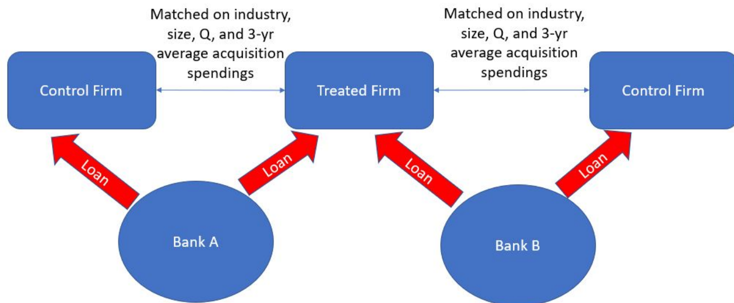
What This Paper Does

IESE Business School University of Navarra

Does lender monitoring only serve as information acquisition, or does it also have real effects on firm behavior?

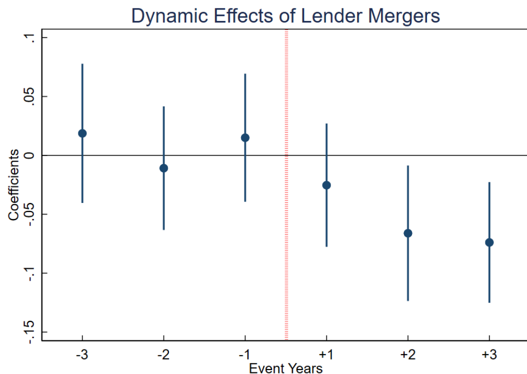
- Difference-in-difference design based on lender mergers (Chu,2019) - banks are unlikely to merge based on factors related to a few particular firms
- Bank mergers are mainly driven by regulatory changes, development in information technology, business strategy reasons such as market penetration (Harford,2005;Jayaraman et al.,2002)
- Lender merger $\uparrow$ skin in the game$\rightarrow$increased incentive to monitor (Sufi,2007;Ivashina,2009)
- A more concentrated loan stake $\downarrow$ coordination problem with other lenders$\rightarrow\uparrow$bargaining power when renegotiating with the manager (Chu,2019)
- Enhanced lender monitoring disciplines managers from taking risky actions

DID Sample



- Bank-specific borrower selection standards
- Market power to command higher loan pricing after merger, economies of scale, etc.

Treatment Effect on Public Takeover Activities



- The effect is solely driven by lender mergers involving a lead lender
- The effect is stronger for firms that are less subject to bank scrutiny and more prone to risk-taking

Implications for Shareholders

IESE Business School University of Navarra

- Lenders mergers reduce not only value-destroying deals, but also value-enhancing ones

Implications for Shareholders

IESE Business School University of Navarra

- Lenders mergers reduce not only value-destroying deals, but also value-enhancing ones
- Deals that do happen target firms with more cash holdings, and lower cash flow volatility

Implications for Shareholders

IESE Business School University of Navarra

- Lenders mergers reduce not only value-destroying deals, but also value-enhancing ones
- Deals that do happen target firms with more cash holdings, and lower cash flow volatility
- Deals that do happen on average create no additional shareholder value

Conclusion

IESE Business School University of Navarra

- Exogenous increases in lead lender "skin in the game" reduce borrowers' public takeover activities
- Cross-sectional results suggest that this link is associated with intensified lender monitoring over managerial discretion
- Managers are more likely to play it safe amid intensified lender monitoring, leading to over-conservative firm policies that are mainly appealing to creditors, but can forgo good growth opportunities for shareholders