Monitoring by Banks as Corporate Governance Mechanism

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Introduction

Inside and outside debt:

**Inside debt:** contract where debt-holder gets access to information from organization’s decision process not otherwise publicly available. The debt-holder may even participate in the decision process on the boards of directors

=> bank loans and other private placements

**Outside debt:** publicly traded debt where debt-holder relies on publicly available information supplied by the organization (also, audit reports and bond ratings). However, virtually all public debt is of investment grade, thus issuers back their public debt with bank credit lines

=> debt instruments: publicly traded bonds, commercial paper, bankers acceptances, bank CD’s

For individuals and small organizations it is cheaper to give one agent (the Bank) direct access to the organization’s decision process than to produce the range of publicly available information that makes outside debt a viable means of financing
Introduction

The financial intermediary (Bank) pools money from investors, lends it and monitors the borrower on their behalf.

Whereas dispersed shareholders may be unable to discipline the management effectively through their voting rights, a bank with a large enough investment will have sufficient incentive to intervene:

⇒ bank lending resolves free riding and collective action problems existing among shareholders regarding monitoring the management.
Moral hazard problems in Bank Lending

Loan contract represents a form under which interest and principal payments by the borrowers is fixed by the agreement.

The borrower is interested in increasing the riskiness of investments to get the highest possible returns net of interest payments. The lender is interested in getting the fixed payments - does not participate in the extra profit but fully bears most of the costs in case of failure.

=>This kind of behaviour leads moral hazard problems.

To mitigate the moral hazard problem, banks monitor the borrowers and sometimes impose collateral requirements on them.
Debt as Governance Mechanism

Bank Monitoring advantages:

1. **Cost advantages** - ongoing history of borrowers as depositors provide information that allows banks to identify the risks of loans to the borrowers and to monitor the loans at a lower cost than other stakeholders.

2. **Expertise in performance evaluation** - lending to a number of firms in the same industry leads to superior screening and monitoring abilities of banks.

3. **Periodic renewals of loans** – requires new updated information about borrower’s financial condition.

4. **Economies of scale in monitoring** – banks usually provide transactions and deposit management services to the borrowers which provides access to a wide pool of information on inflows and outflows between suppliers, customers, employees and makes it easy to stay updated and react quickly to discoveries of delays in payments to other stakeholders.

5. **Documentations supporting the debt** – on the compliance (or violations) of debt covenants => much more timely communication than public disclosure requirements.

6. **Representation on boards** of borrowers - offers one more avenue of active monitoring.
Advantages of bank monitoring to other stakeholders:

The decision to lend signals the quality of the borrower to other stakeholders:
   i) banks obtain private info ex ante and their decisions to lend translate into good value and higher creditworthiness of the borrowers;
   ii) reflects the value of future bank monitoring over the life of the loan

The imposition of fixed regular interest and principal payments under loan agreements reduces the amount of free cash flow at managers’ disposal
   => less managerial slack (like perks and empire building)

When lenders are endowed with priority rights over borrowers’ assets – it constrains managers to liquidate non cash assets and/or selling more debt in the future
   => less sources of free cash flow to managers

Loan covenants constrain borrowers of specific behaviours without bank’s consent, like:
   dividends and new debt issues, increases the need to maintain working capital and lower the riskiness of the projects undertaken, maintain healthy financial condition: total capital to debt, CF relative to debt service obligations etc.
Other signalling features of bank debt

Through the course of monitoring, upon discovering alarming information - banks can either exit or intervene

Exit - limit borrowers investments by not providing additional financing, accelerate the maturity of the outstanding debt, refuse to renew existing debts, seize borrowers assets against their claims

⇒ Bank exit is treated as observable signal of managerial slack. The action sends an early signal to other stakeholders that prompts them to act earlier than they might have otherwise in order to intervene in controlling the management

Bank’s possible exit creates the sense of urgency among management and the board and incentivizes them to take corrective actions. The effectiveness of bank monitoring depends on the consequences of its exit ⇒ in many cases it deters managerial slack ex ante and/or induces corrections ex post
Bank Intervention - banks may also defer exit and use the threat of exit as a lever to intervene in firms’ decisions

=> exercise their voice - the ability to influence management and improve firm performance

Bank monitoring and reaction may correct managerial slack either directly, by precipitating a crisis in the boardroom and exercising voice, or indirectly, by exiting and providing a signal for the intervention of others

Once the firm defaults the bank’s ability to discipline management is much greater than with traditional governance mechanisms
Disadvantages of Bank Loans - Agency costs of debt:

• The direct monitoring costs by the bondholders

• Conflicts of interests between creditors and shareholders. As agents of their shareholders managers have incentives to make decisions that transfer wealth from debt-holders to shareholders. Banks also have incentives to use their monitoring and voice powers to benefit at the expense of other stakeholders

• Foregone investing opportunities - the wealth loss caused by the impact of debt on future investment decisions of the firm

• Conflict of interest between different creditors: If the monitoring creditor detects the misbehaviour sooner than other creditors, the latter are less likely to be paid after the former

• High firm leverage leads to higher probability of bankruptcy and financial distress
The value of bank loans from shareholders’ perspective

• Bank loans may be value-enhancing for borrowers if the lenders provide monitoring functions for the borrowing firms, especially when the latter have weak internal governance structures

• Do bank lenders substitute for an effective corporate governance at the borrowing firms?
Investors’ Reaction to Bank Loan Announcements

Study of 800 bank loan announcements in 1980-2003

Analysis of cumulative abnormal returns (CARs) two days around the loan announcements

The hypothesis: Bank loans are less important for firms with good corporate governance (due to less need for bank monitoring) and vice versa.

=> bank loans are substitute for firm corporate governance

The better the internal control mechanisms – the less the abnormal reaction of investors to bank loan announcements
Quality of the borrowers’ corporate governance:

1. Board Size & Composition (smaller boards & independent directors)

2. Ownership by insiders (the more the ownership the less the conflicts of interests)

3. Ownership by large shareholders (>5%) (more monitoring of the management)

4. Ownership by Institutions (more monitoring of the management)

5. CEO incentive based compensation (the more the incentives the less the conflicts of interests)

6. The threat of takeovers – external corporate governance mechanism (disciplining tool of management)
Bank loans are viewed as a substitute for weak corporate governance. If other lenders are already providing monitoring, an additional loan may not be considered as necessary in substituting for the firm’s corporate governance.

Abnormal returns are higher around bank loan announcements when the announcing firm has weak corporate governance:
- lower % of independent directors on board
- lower stock ownership of the insiders
- lower CEO incentive based compensation
- lower the threat of takeovers

Table 3: P values in parentheses
Ordinary least squares regressions of bank loan announcement abnormal returns and firm corporate governance characteristics

<table>
<thead>
<tr>
<th>Variable</th>
<th>Model</th>
</tr>
</thead>
<tbody>
<tr>
<td>Intercept</td>
<td>0.4380 (0.3906)</td>
</tr>
<tr>
<td>Independent board (%)</td>
<td>-0.0184 (0.0375)</td>
</tr>
<tr>
<td>Officer and director ownership (%)</td>
<td>-0.0211 (0.0187)</td>
</tr>
<tr>
<td>CEO incentive pay (%)</td>
<td>-0.0120 (0.0400)</td>
</tr>
<tr>
<td>Institutional ownership (%)</td>
<td>-0.0056 (0.3855)</td>
</tr>
<tr>
<td>Total assets (log)</td>
<td>-0.0002 (0.8977)</td>
</tr>
<tr>
<td>Debt ratio (%)</td>
<td>-0.0160 (0.0734)</td>
</tr>
<tr>
<td>ROA (%)</td>
<td>-0.0165 (0.2139)</td>
</tr>
<tr>
<td>Standard deviation of stock returns (%)</td>
<td>-0.0231 (0.8546)</td>
</tr>
<tr>
<td>Syndication dummy</td>
<td>0.0027 (0.5214)</td>
</tr>
<tr>
<td>M&amp;A activity dummy</td>
<td>-0.0063 (0.0653)</td>
</tr>
<tr>
<td>Year</td>
<td>-0.0002 (0.4288)</td>
</tr>
<tr>
<td>N</td>
<td>784</td>
</tr>
<tr>
<td>F-statistic</td>
<td>1.93**</td>
</tr>
<tr>
<td>Adjusted $R^2$</td>
<td>0.0210</td>
</tr>
</tbody>
</table>

If other lenders are already providing monitoring, an additional loan may not be considered as necessary in substituting for the firm’s corporate governance.
Division of sample into two groups:

1) Firms from industries with high Mergers & Acquisitions activities (M&A=1)
2) Firms from industries with low M&A activities (M&A=0)

Hypothesis: loan announcement returns on bank loans are higher for firms with weak markets for corporate control (M&A=0)

Bank monitoring substitutes for some corporate governance attributes in markets where external corporate control is weak

Table 4  P values in parentheses

Ordinary least squares regressions of bank loan announcement abnormal returns corporate governance characteristics for firms with and for firms without market for corporate control activity

<table>
<thead>
<tr>
<th>Variable</th>
<th>Model 1a M&amp;A = 0</th>
<th>Model 1b M&amp;A = 1</th>
</tr>
</thead>
<tbody>
<tr>
<td>Intercept</td>
<td>0.4167 (0.4711)</td>
<td>1.4586 (0.0547)</td>
</tr>
<tr>
<td>Independent board (%)</td>
<td>-0.0236 (0.0214)</td>
<td>0.0008 (0.9555)</td>
</tr>
<tr>
<td>Officer and director ownership (%)</td>
<td>-0.0158 (0.1108)</td>
<td>-0.0235 (0.1103)</td>
</tr>
<tr>
<td>CEO incentive pay (%)</td>
<td>-0.0149 (0.0311)</td>
<td>-0.0091 (0.3450)</td>
</tr>
<tr>
<td>Total assets (log)</td>
<td>-0.0008 (0.5472)</td>
<td>-0.0013 (0.4165)</td>
</tr>
<tr>
<td>Debt ratio (%)</td>
<td>-0.0087 (0.3919)</td>
<td>-0.0338 (0.0235)</td>
</tr>
<tr>
<td>ROA (%)</td>
<td>-0.0083 (0.6022)</td>
<td>-0.0257 (0.1662)</td>
</tr>
<tr>
<td>Year</td>
<td>-0.0002 (0.5112)</td>
<td>-0.0007 (0.0596)</td>
</tr>
<tr>
<td>N</td>
<td>545</td>
<td>294</td>
</tr>
<tr>
<td>F-statistic</td>
<td>1.94**</td>
<td>1.58*</td>
</tr>
<tr>
<td>Adjusted $R^2$</td>
<td>0.0235</td>
<td>0.0271</td>
</tr>
</tbody>
</table>
Summary

Banks as monitors are substitutes for some internal corporate governance mechanisms.

Loan announcement abnormal returns are higher for firms that have weaker corporate governance structures (firms with boards dominated by inside directors, with low stock ownership by the insiders and CEOs with low incentive based pay).

\[=\rightarrow\] investors perceive bank loans as good news because of the possible future monitoring.

Banks substitute for corporate governance only for those borrowers which are exposed to weak external market for corporate control (low threat of takeovers).

\[=\rightarrow\] If M&A markets are active there is already sufficient monitoring for firms. The possible bank monitoring is not perceived as adding value.
Does Bank Monitoring Constrain Managerial Slack?

The purpose of bank monitoring is to reduce bank’s credit risk by preventing the opportunistic behavior of the borrower (moral hazard)

=>Borrower’s opportunistic behavior (moral hazard) = Earnings management

Q: Is bank monitoring successful in decreasing moral hazard?

Examine the effect of bank monitoring on a borrowing firm’s earnings management behavior

**Hypothesis:** Negative relationship between the strength of bank monitoring and borrower’s earnings management is predicted
Incentives for earnings management around debt financing:

**Ex-ante:** Banks typically approve loans to financially healthy borrowers giving managers ex-ante incentives to manage earnings to increase their borrowing capacity (high loan amounts, lower interest rates and other contracting costs)

**Ex-post:** After issuing loans managers address to ex-post earnings manipulation to avoid debt covenant violation alarms

Bank’s credit risk is affected by the degree of earnings management, therefore they perform monitoring activities incentivize borrowers to avoid earnings management

**Earnings management measure = discretionary accruals:**

\[
\text{positive value} = \text{earnings manipulation (possible early recognition of revenues)}
\]
Brief note on discretionary accruals

Accrual Basis of Accounting:
- Revenues are recognized when earned (without any regard to the timing of cash collection) => balance sheet item in Assets = Unearned Revenue
- Expenses are recognized when incurred => balance sheet item in Liabilities = Accrued Expense

We can disaggregate reported earnings into cash flows and accruals using balance sheet approach:

**Accruals = Change in Net Operating Assets**

Net Operating Assets = Operating Assets – Operating Liabilities
Operating Assets = Total Current Assets – Cash items
Operating Liabilities = Total Current Liabilities – Total debt

(=> distinguish between cash items and other operating non-cash items like inventories, unearned revenues, deferred taxes etc.)
The measures of the strength of bank monitoring:

- **The magnitude of a bank loan**: higher the value of loan greater the stake of the bank - greater the incentive to monitor

  $=>$ Borrower’s earnings management should decrease as the magnitude of bank loan (and consequently bank monitoring) increases

- **The reputation of the lead bank**: Banks with high credit ratings are highly motivated to monitor borrowers to maintain their credit ratings which stand proxy for reputation

  $=>$ Earnings management will be lower for borrowers with a high reputation lead bank
The measures of the strength of bank monitoring:

• **The length of a bank loan:** banks with long-term relationships with borrowers gain advantages when obtaining private information from borrowers - their monitoring ability becomes stronger

  => Borrower’s earnings management should decrease as the length of bank loan increases

• **The number of lenders:** syndicated loan – a group of banks lending to a single borrower. It is common for each participating bank to perform an independent analysis of the borrower’s credit risk - more intensive monitoring than with a sole lender

  => Borrower’s earnings management should decrease as the number of lenders increase
The effect of bank monitoring strength on borrower’s earnings management

The results are significant for the three measures of bank monitoring strength – the higher amount of the loan, the more reputation of the lender and the longer –term loan outstanding – all contribute to decreased levels of earnings management in the borrowing firms.

Though the effectiveness of bank monitoring is not increasing with the number of lenders.

Monitoring intensity of the lead bank decreases as the number of borrowers increases.

Table 3
Bank monitoring and borrowers’ earnings management

<table>
<thead>
<tr>
<th>Independent variables</th>
<th>Coefficient</th>
<th>t-Statistics</th>
</tr>
</thead>
<tbody>
<tr>
<td>Magnitude</td>
<td>-0.0628</td>
<td>-2.03**</td>
</tr>
<tr>
<td>Ranked</td>
<td>-0.0141</td>
<td>-1.74**</td>
</tr>
<tr>
<td>Length</td>
<td>-0.0047</td>
<td>-2.32**</td>
</tr>
<tr>
<td>N_Lender</td>
<td>-0.0009</td>
<td>-1.50</td>
</tr>
<tr>
<td>N_Borrower</td>
<td>0.0015</td>
<td>1.67**</td>
</tr>
<tr>
<td>Auditor</td>
<td>-0.0068</td>
<td>-0.50</td>
</tr>
<tr>
<td>BM</td>
<td>-0.0074</td>
<td>-1.32</td>
</tr>
<tr>
<td>LogMVE</td>
<td>-0.0026</td>
<td>-0.71</td>
</tr>
<tr>
<td>ROA</td>
<td>0.1621</td>
<td>1.39</td>
</tr>
<tr>
<td>FreeCF</td>
<td>0.0000</td>
<td>0.71</td>
</tr>
<tr>
<td>Leverage</td>
<td>-0.0279</td>
<td>-1.20</td>
</tr>
<tr>
<td>Coverage</td>
<td>-0.0001</td>
<td>-1.53</td>
</tr>
<tr>
<td>AltmanZ</td>
<td>0.0009</td>
<td>0.60</td>
</tr>
<tr>
<td>R²</td>
<td></td>
<td>0.164</td>
</tr>
<tr>
<td>N</td>
<td></td>
<td>3260</td>
</tr>
</tbody>
</table>
Other Bank Loan Characteristics and Earnings Management

**Collateralized loans**: loans secured by borrower’s tangible assets – credit risk of the loan decreases

=>Lender’s monitoring incentives might decrease (less need for bank monitoring)

**Refinancing loans**: restructuring the existing debt with a new one. Refinancing risk – faced by borrowers – is the probability that a borrower will be unable to refinance or repay the existing debt.

=>Banks will monitor more to reduce the potential refinancing risk

**Loan Types** - term loans vs. others: Lender’s uncertainty decreases and effectiveness of bank monitoring increases in term loans (as opposed to revolver loans)
Use of collateral reduces lender’s monitoring incentives

Loan Refinancing is insignificant

Term Loans increase lender’s monitoring incentives
Summary

Q: Does bank monitoring affect managerial moral hazard (earnings management)?

The results showed that the strength of bank monitoring — the magnitude of the loan, the reputation of the bank and the length of the loan — is negatively related to the borrowing firm’s earnings management.

=> bank monitoring plays an important role in constraining managers’ opportunistic financial reporting behavior.
References:


Thursday, Oct 30 - Presentation

Optional Readings/Presentations:
