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Default resolution and access to fresh credit in an emerging market☆

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ABSTRACT

We examine loan defaults by firms and identify the factors that influence both the default resolution process and firms' access to fresh credit after firms exit default. Using a dataset of all commercial loans made in Pakistan from 2006 to 2013, we find an important role for collateral. Collateral expedites both the default resolution process and access to fresh credit after exiting default. Higher interest rates increase the default duration. Relationships with multiple lenders as well as those with multiple branches of one lender are associated with obtaining fresh credit at the post default stage.

1. Introduction

Failure to repay loans is at the core of banking crises (Reinhart and Rogoff, 2009). The net costs of resolving banking crises have been estimated at about 13.3% of GDP, with these costs much higher in emerging economies (Laeven and Valencia, 2008). An efficient default resolution mechanism is in the interest of every economic agent, be it banks, businesses or the economy as a whole. Tedious, time consuming and unsuccessful default negotiations are costly to both banks (in the form of loan losses) and firms (through higher risk of insolvency and reputational loss), as well as to the economy as a whole (Hart and Moore (1998) observe that post default lack of trust between lender and borrower causes the liquidation of many viable businesses). Since bank credit is a dominant source of funds for businesses in emerging economies (Fan et al., 2012), access to fresh loans after default resolution is critical for the very survival of firms. Both default resolution and access to fresh credit after exiting default thus have strong linkages with financial stability and economic growth.

Despite the importance of default resolution and access to fresh credit for defaulting firms, these subjects have received only limited attention in the literature. While reorganizations under formal insolvencies regimes like Chapter 11 have been examined in detail, there have been few studies on corporate default resolution through private channels.[1] Two studies though have examined formal versus informal resolutions: Blazy et al. (2014) find that larger loans with long term maturities are restructured through private negotiations; whereas Hotchkiss et al. (2014) observe that firms backed by private equity also prefer informal

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[1] Chapter 11 is a component of the US bankruptcy code that governs reorganization of a firm.

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channels for loan renegotiations. A few other studies have examined the role of particular variables of interest on default resolution: Bester (1994), in a theoretical paper, argues that collateral helps renegotiations; however, Karagozoglu et al. (2008) find that collateral increases the probability of liquidation in case of default; and Chan et al. (2014) examine mortgage loans and find that loans of borrowers with low credit scores are more likely to be restructured.

The topic of access to fresh credit after default resolution is reported in the literature even less than default resolution. To the best of our knowledge, Bonfim et al. (2012) present the only study on this topic. They find that most of the borrowers in Portugal are able to maintain access to credit even after default; however, few of them are able to get fresh loans. The large firms having multiple credit relationships are in a better position to access credit markets after clearing default. Further, access to credit becomes difficult if default is with the main bank of the borrower or if the duration of default is long. Bonfim et al. (2012) study, however, does not examine the role of collateral and interest rates in default resolution nor does it consider these variables while evaluating access to fresh credit: these variables are not available in the dataset. Our study, in contrast, is the first to examine the role of collateral and interest rate in default resolution and access to fresh credit.

We use a unique dataset of *all* loans in Pakistan, from April 2006 to December 2013.[2] Our dataset has been sourced from the Credit Information Bureau (CIB) of the State Bank of Pakistan (SBP).[3] All financial institutions in Pakistan are legally obligated to report complete information about their borrowers to CIB on a monthly basis and thus the database covers *every* firm which has availed itself of *any* financing facility from *any* financial institution in Pakistan.[4] The limited research on bank-borrower post default relationships and subsequent access to credit after default resolution could be due to the nature of the required data. The number of defaults is generally a very small percentage of total credit transactions. As a result, even if one is able to gain access to the complete records of one or even a few banks, the small number of observations makes a meaningful analysis difficult. We overcome the limitations of data availability by examining *all* the credit transactions in an economy.

Our contribution to the literature is three fold. First, to the best of our knowledge, this is the first study that examines the impact of collateral and interest rate on default resolution and access to fresh credit after clearing default. More importantly, in addition to examining the collateral per se, our dataset allows us to consider the role of different types of collateral in default resolution and access to fresh credit. Secondly, this study examines default resolution and access to credit from the perspective of a developing country. The design and enforcement of creditor rights in a country can have a material impact on economic relationships (la Porta et al., 1998). As we explain in Section 6.1, the judicial system in Pakistan is inefficient and susceptible to pressure. Thirdly, we are able to examine the role of relationships in default resolution and access to fresh credit. Our dataset allows us to test the proposition of Bolton and Scharfstein (1996) that credit relationships with more banks are associated with inefficient reorganization because of coordination problems.

Our results suggest that defaulters in Pakistan behave differently to those in Portugal as studied by Bonfim et al. (2012). Indeed, in contrast to Bonfim et al. (2012), who observe that default duration is shorter for large firms, we find that larger borrowers take more time for default resolution. This is consistent with institutional differences in both countries.[5] The Pakistani dataset allows us to precisely determine when a borrower obtains fresh credit after clearing default. We consider a firm having accessed fresh credit after clearing default only when it obtains a new loan.[6] We find that borrowers in Pakistan need more time (10 months for first 25% firms) to access fresh loans after default resolution than the borrower in Portugal (6 months for first 25% firms).

The Pakistani dataset also provides information on collateral and interest rates (factors which could not be considered by Bonfim et al.). We find that the collateral is helpful in both expediting the default resolution process and in establishing access to fresh credit after exiting default. Regarding the effect of types of collateral, we observe that mortgages of both the residential and commercial property are helpful in resolving default. Higher interest rates increase the duration of default, suggesting that the higher credit pricing makes it difficult for a borrower in distress to service the loan and come out of default quickly. Interest rates do not play any significant role in accessing fresh credit after default resolution. Contrary to the notion that banks can lend to higher risk customers by charging greater risk premium, financial institutions in Pakistan perhaps decline the customers considered bad credit risk by them as observed by Stiglitz and Wejss (1983).

Default with more than one financial institution makes default resolution difficult perhaps owing to coordination problems among lenders (Brunner and Krahnen, 2008). We however, also observe a similar effect when a borrower in default has a credit relationship with a higher number of branches of the lender, or is availing multiple financing products from it. This shows that coordination can be a problem not only between lenders but also between branches of one financial institution. Quite

[2] Pakistan is the 6th largest country in terms of population with around 180 million people. It stands at 35th position in terms of area and at 45th position in terms of GDP at around US$ 233 billion (IMF World Economic Outlook – April 2015). The Karachi Stock Exchange is the largest stock exchange in Pakistan, ranked at 50th position in terms of market capitalization (WDI report by World Bank available at http://databank.worldbank.org/data/download/WDI-2013-ebook.pdf accessed on November 29, 2014).

[3] The State Bank of Pakistan is the central bank of the country entrusted with dual responsibilities of conducting monetary policy as well as banking supervision in Pakistan.

[4] Financial institutions under the regulatory domain of the SBP are obliged to provide credit information under Section 25A of the Banking Companies Ordinance, 1962. Further, the Securities and Exchange Commission of Pakistan (SECP) has also advised financial institutions falling under its regulatory ambit to submit credit information to CIB. Thus all financial institutions are comprehensively covered.

[5] As we explain in Section 6.1, large borrowers can exploit the weak creditor rights regime and Pakistan's inefficient judicial system.

[6] This definition is stricter than Bonfim et al. (2012) who define access as availability of any sort of financing facility after clearing default "broad access" or an increase in the total credit outstanding "strict access". Total credit outstanding may simply increase because of accrual of interest and may not actually reflect the borrower's ability to access fresh credit.