Journal of Financial Economics 109 (2013) 517–534

Contents lists available at SciVerse ScienceDirect

Journal of Financial Economics

journal homepage: www.elsevier.com/locate/jfec

Corporate ownership structure and the choice between bank debt and public debt[☆]

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ARTICLE INFO

Article history:
Received 1 May 2012
Received in revised form
28 August 2012
Accepted 19 September 2012
Available online 2 April 2013

JEL classification:
G21
G32

Keywords:
Ownership structure
Excess control rights
Bank Debt
Public Debt

ABSTRACT

This article examines the relation between a borrowing firm's ownership structure and its choice of debt source using a novel data set on corporate ownership, control, and debt structures for 9,831 firms in 20 countries from 2001 to 2010. We find that the divergence between the control rights and cash-flow rights of a borrowing firm's largest ultimate owner has a significant negative impact on the firm's reliance on bank debt financing. In addition, we show that the control-ownership divergence affects other aspects of debt structure including debt maturity and security. Our results indicate that firms controlled by large shareholders with excess control rights may choose public debt financing over bank debt as a way of avoiding scrutiny and insulating themselves from bank monitoring.

1. Introduction

Why do some firms borrow mainly from arm's-length investors such as public bondholders while others rely much more on informed financial intermediaries such as banks as their debt providers? This is an important question as both bank loans and public bonds are major sources of global corporate financing.[1] Existing corporate theories provide various explanations for the benefits and costs of using bank debt versus public debt (e.g., Diamond, 1984, 1991; Fama, 1985; Rajan, 1992; Park, 2000). Yet, despite the theoretical and empirical importance of credit markets, there is only limited evidence on the determinants of the choice between private and public debt financing. For instance, using a panel data set of 250 publicly listed firms in the U.S., Houston and James (1996) investigate the relation between a firm's growth opportunities and its mix of private and public debt claims. More recently, Denis and Mihov (2003) examine the link between a firm's credit quality and its choice of debt source. Most of the existing studies focus on firms in the

☆ We thank Ben Esty, Paul Gompers, Joel Houston, Rafael La Porta (the referee), Andrei Shleifer, Bill Schwert (the editor), Belén Villalonga, and seminar participants at Nanyang Business School for thoughtful comments and suggestions. We thank Pennie Wong for help with data collection. Lin and Xuan gratefully acknowledge the financial support from Chinese University of Hong Kong/the Research Grants Council of Hong Kong (GRF 448412) and the Division of Research of the Harvard Business School, respectively.
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[1] Using the year 2009 as an example, international syndicated lending alone amounted to $1.8 trillion and, meanwhile, corporations borrowed another $1.5 trillion in international bond markets (Chui, Domanski, Kugler, and Shek, 2010).

0304-405X/$ - see front matter
http://dx.doi.org/10.1016/j.jfineco.2013.03.006

U.S. and explore firm *financial* characteristics as potential factors influencing firms' debt choices. In this paper, we focus on the ownership structure of borrowing firms. Specifically, we explore the effect of the divergence between ownership and control on debt choice using a unique, hand-collected international panel data set that covers more than 9,800 firms in 20 countries from 2001 to 2010.

Existing theories on ownership structure and corporate debt financing choice offer different views on the relation between firm control-ownership divergence and the choice between bank debt and public debt. On the one hand, compared to public debt holders, banks have significant comparative advantages in monitoring efficiency due to access to private information as insiders (Fama, 1985). Superior access to information enables banks to detect expropriation or opportunistic activities by controlling shareholders and corporate insiders and, accordingly, to punish the offending borrowers either by liquidation or through renegotiation (Park, 2000). As a consequence, bank monitoring reduces moral hazard problems and provides borrowers strong incentives to make appropriate corporate decisions (Stiglitz and Weiss, 1983; Rajan, 1992). In contrast, the diffuse ownership of public debt and the resulting free rider problems weaken individual bondholders' incentives to engage in costly monitoring (Diamond, 1984, 1991). Even if many bondholders were willing to monitor, the monitoring itself would be inefficient as it would involve wasteful duplication of monitoring efforts and costs (Houston and James, 1996). In short, the combination of concentrated holdings, credible threats, and superior access to information makes banks much more effective monitors than public bondholders in deterring potential self-interested or self-dealing activities.[2] Therefore, controlling shareholders and corporate insiders are less likely to be able to extract private benefits at the expense of other shareholders under bank monitoring (Hoshi, Kashyap, and Scharfstein, 1993). From this perspective, firms with greater monitoring needs (e.g., those with greater agency problems) should borrow privately from banks while firms with lower monitoring needs should borrow more from arm's-length public investors (Houston and James, 1996; Denis and Mihov, 2003). Since the divergence between ownership and control induces significant agency problems between large shareholders and other investors (e.g., Shleifer and Vishny, 1997), it follows that there should be a positive relation between corporate control-ownership divergence and the borrowing firm's reliance on bank debt.[3]

On the other hand, controlling shareholders' incentives to engage in expropriation activities and elude monitoring may imply the opposite relationship between the control-ownership divergence and firm debt choice. The literature on corporate ownership structure documents widespread divergences between the control and cash-flow rights of dominant shareholders. These divergences arise from the use of pyramid ownership structures, multiple control chains, and dual-class shares in many public firms around the world (e.g., La Porta, López-de-Silanes, and Shleifer, 1999; Claessens, Djankov, and Lang, 2000; Laeven and Levine, 2008; Lin, Ma, Malatesta, and Xuan, 2011). In such firms, the high control rights enable the controlling shareholders to engage in various self-dealing activities to divert corporate resources for private benefits while the low cash-flow rights expose the controlling shareholders to very limited direct financial costs of such activities (Shleifer and Vishny, 1997; Johnson, La Porta, López-de-Silanes, and Shleifer, 2000).[4] Consequently, the tunneling incentives in these firms increase with the wedge between control rights and cash-flow rights. Tunneling activities by controlling shareholders heighten the risk of financial distress and default, impair collateral value, and increase expected bankruptcy costs. Taking these agency costs into account, banks are more likely to impose particularly strong monitoring on borrowing firms with large divergences between ownership and control.[5] In anticipation of the strict monitoring by banks, firms controlled by large shareholders with excess control rights might prefer public debt financing over bank debt as a way of avoiding scrutiny and insulating themselves from bank monitoring. These considerations, therefore, suggest a negative relation between corporate control-ownership divergence and a borrowing firm's reliance on bank debt.

The overall effect of the borrowing firm's control-ownership divergence on its choice between bank debt and public debt is an empirical question that we explore in this paper. To investigate this, we construct a new, hand-collected large data set on corporate ownership structure and debt structure for more than 9,800 publicly listed firms across 20 East Asian and West European countries during the period 2001–2010.[6] Using this large international data set, we find strong evidence that is consistent with the bank monitoring avoidance hypothesis. Our results indicate that firms with wider divergences between controlling shareholders' voting rights and cash-flow rights tend to rely more heavily on public debt financing and less on bank debt financing. The effect is not only statistically significant but also economically significant.

[2] This is consistent with evidence based on stock market reactions documented in James (1987), which shows that the stock market reacts more positively to firm announcements of bank loans than to announcements of public debt offerings.

[3] It is possible that the link between control-ownership divergence and bank debt reliance weakens when bank debt accumulates to a certain level beyond which banks' incremental monitoring incentives get smaller. We explore this possibility in Section 3.3.2.

[4] Examples of these activities include asset sales, asset and cash-flow transfers, inter-corporate loans, and investment activities that generate private benefits for the controlling shareholders while harming firm performance as well as the interests of other investors (e.g., Johnson, La Porta, López-de-Silanes, and Shleifer, 2000; Djankov, La Porta, López-de-Silanes, and Shleifer, 2008).

[5] Indeed, Lin, Ma, Malatesta, and Xuan (2012) find strong evidence that banks form syndicates with structures that facilitate monitoring when the control-ownership divergence is large.

[6] We focus on these East Asian and Western European countries because it has been shown that the control-ownership divergence is prevalent and has significant effects on firm value among firms in these countries (e.g., Claessens, Djankov, and Lang, 2000). We focus on publicly listed firms because these firms are most likely to find public debt financing feasible and thus most likely to confront the choice between bank debt and public debt.