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Lender's risk incentive and debt concession

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Abstract

This paper demonstrates that a lender's risk incentive may render it difficult to conduct efficient debt renegotiation. When a lending bank has a risk incentive, the bank is not likely to make a debt concession, even though such a concession could resolve inefficiencies caused by a borrower's risk incentive. If the lender refrains from renegotiation the debt, then the borrowing firm chooses a value-decreasing risky project. As a result, the cash flow that the lending bank collects becomes risky, and the wealth of the bank's shareholders increases. The lender's risk incentive thus accelerates the borrower's risk incentive.

JEL classification: G21; G31
Keywords: Bank risk incentive; Debt concession

1. Introduction

Debt renegotiation is often desirable for a borrowing firm in financial distress because it resolves inefficiencies caused by suboptimal decisions made by the firm or its stakeholders. However, several studies have pointed out that ex-post debt renegotiation is difficult. For example, Giammarino (1989) and Heinkel and Zechner (1993) show that informational asymmetry between the borrowing firm and outside creditors is a hindrance to efficient debt restructuring. Gertner and Scharfstein (1991), James

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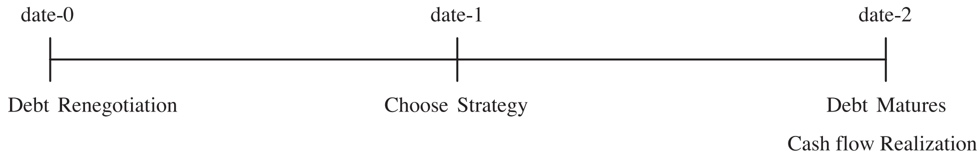

Fig. 1. Sequence of events.

(1995), and Detragiache and Garella (1996) point out that debt renegotiation often can not be agreed upon due to conflicts among multiple creditors when the borrowing firm has a number of different creditors (Fig. 1).

This paper provides an alternative explanation for the difficulty of debt renegotiation, i.e., the lender's risk incentive. Let us consider a typical risk incentive problem of a levered firm in financial distress, which borrows from only one bank. It is a well known problem of risk incentive that shareholders of the levered firm are likely to prefer a risky investment to a safe one, even though a risky project is less valuable than a safe one.[1] The risk incentive of the borrowing firm decreases the value of a bank loan as well. By forgiving debt, the risk incentive problem of the borrowing firm can be resolved, and then the borrowing firm undertakes a safer, value-increasing project. As a result, both the total value of the firm itself and the expected amount of money that the lending bank can collect increase.

From the viewpoint of the lending bank, while debt concession enhances the value of the loan to the firm, it may decrease the wealth of its shareholders. Along the same lines in the case of the borrowing firm, shareholders of the lending bank may prefer a risky collection of the loan to a stable collection, even though the risky collection is less valuable than the stable one. In particular, when the financial condition of the lending bank is unhealthy, shareholders of the bank have a risk incentive, as do the shareholders of the borrowing firm.[2] If the bank management pursues the shareholders' wealth at the cost of the creditors (e.g., the depositors), then debt concession does not occur. Thus, the model presented in this paper shows that the risk incentive at a lending bank renders efficient debt renegotiation impossible, even if neither informational asymmetry nor conflicts among creditors exist.

On the other hand, if the management of the lending bank takes actions that are not in the interest of the shareholders' wealth, then debt concession might decrease the equity value of the unhealthy lending bank. For example, the management may prefer a stable loan collection to a risky collection in order to avoid bankruptcy in which the management will lose its position. In such a case, the bank management has an incentive to forgive debt, after which the indebted firm undertakes a safer project and the bank can achieve stable collection of the loan. It is also possible that management of a main lending bank chooses to rescue the indebted firm in financial distress in order to maintain its good reputation. In such a situation, it seems reasonable to suppose that the management of a lending bank will agree to debt concession with little concern for the shareholders' interests.

[1] For a discussion of a risk incentive problem, see Jensen and Meckling (1976), Gavish and Kalay (1983), Green (1984), and Green and Talmor (1986).

[2] Saunders, Strock, and Travlos (1990) and Demsetz and Strahan (1997) empirically found a positive relationship between managerial shareholdings and bank risk-taking (market risk measure) in the U.S. Anderson and Fraser (2000) also reported that managerial shareholdings were positively related to both total risk and firm-specific risk in the late 1980s, when the U.S. banking industry was under unhealthy financial conditions. John, John, and Senbet (1991) and Goldberg and Harikumar (1991) theoretically argued the relationship between bank risk-taking incentives and the design of deposit insurance.