When do Laws and Institutions Affect the Recovery Rate of Collateral?

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OeNB Workshop on Using Microdata for Macroprudential Policy, 18-19 September 2014

Research Question

- Do legal institutions (creditor rights) affect efficiency of secured lending?
  - Do legal institutions affect banks’ capacity to enforce debt contracts i.e. banks’ expected recovery rate on collateral?
    - How? Through which channels?
  - Does impact of low creditor protection on recovery expectations translate into changes in contracting terms (cost of capital)?

Main Findings

- Creditor rights affect efficiency of secured lending
  - Creditor protection affects differential impact of collateral types on expected recovery rate
    - Larger recovery rate spread between divertible and non-divertible collateral in low creditor protection countries than in high creditor protection countries
    - Mechanisms: Legal institutions mitigate agency risk and facilitate redeployability of firm specific assets
  - Negative effect of lack of creditor protection on expected collateral recovery translates into stricter contracting terms (higher cost of capital)

Identification Strategy

- Detailed loan level cross-country dataset ensures thorough identification strategy
  - Estimate within country differences in the impact of use of divertible and non-divertible collateral on banks’ expected recovery rates, for countries with different levels of creditor protection
  - Use of country effects ensures identification of causal impact of creditor protection on recovery rates

Identification Strategy Con’t

- Detailed loan level cross-country dataset ensures thorough identification strategy
  - Estimate differences in the impact of use of divertible and non-divertible collateral on banks’ expected recovery rates i) for borrowers within same country, same industry, at same quarter, ii) for same borrower, in countries with different levels of creditor protection
  - Use of i) country-industry-time, ii) borrower fixed effects ensures strong identification of causal impact of creditor protection

Comment 1:
Connection to Liberti and Mian (2010)

- Distinction vis-a-vis Liberti and Mian (2010) could be emphasized more for reader „uneducated" in field (currently only similarities explained)
  - Same dataset, same classification of collateral assets
  - But: LM (2010) focus on impact of institutional environment on collateral demand for given project risk (i.e. process of collateralization) rather than (expected) efficiency of collateral contract enforcement

Comment 2: Bank relationships

- Multiple bank relationships, seniority of claim
  - Bank’s expected recovery rate may be lower when other claimholders are more senior, and seniority may also affect the type of collateral bank may ask for
  - Identify subsample of firms with only one bank?
  - If no information on bank relationships or seniority of claim, is it possible to stretch identification further?
    - Estimate within-loan differences in impact of divertible and non-divertible collateral on recovery rates? Perhaps for small sub-sample of dataset?
    - Section II: ‚… loans are secured by multiple asset classes’

Comment 3: Role of Firm Size

- Are results driven by presence of small firms in the sample?
  - Small firms are substantial part of sample. Small (and young(?)) firms may have less non-divertible assets.
  - Estimate impact of creditor protection on difference between recovery rates on divertible and non-divertible collateral only for large size firms

Comment 4: Impact on Contract Terms

- Do banks use other contracting terms (beyond interest rate) to compensate for negative effect of low creditor protection on expected recovery rates?
  - Amount of collateral relative to loan size?
    - Higher collateral size along with higher interest rates may substitute for low creditor protection?
  - Maturity of loan?

Further Comments

- Expected recovery rate is subjective measure of contract enforcement
  - Can you describe rating procedure? Is it same officer that sets expected recovery rate for all SME loans in same country? Can we exclude possibility of „officer bias" affecting results?
- More descriptive statistics about frequency and distribution of collateral types (asset classes) across borrowers would be nice
  - Again, difficult to assess whether you could run specifications with loan or borrower-time fixed effects?
- Specification with clustering of standard errors in both country and time dimensions could be added to adjust for correlation across observations at same quarter

Conclusion

- Excellent and clearly written paper on impact of creditor rights on efficiency of collateral contract enforcement
- Authors explore advantages of micro-data to study research question that requires data with variation at country level
  - Great identification strategy
- Important contribution
  - Little research so far on impact of creditor rights on efficiency of collateral contract enforcement