Does Bank Monitoring Matter to Bondholders?

Joel F. Houston
University of Florida
Hong Kong Institute for Monetary Research

and

Chen Lin
The University of Hong Kong
Hong Kong Institute for Monetary Research

and

Junbo Wang
City University of Hong Kong
Hong Kong Institute for Monetary Research

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Summary

In this paper, we examine the existence of a cross-monitoring effect between bank debt and public debt by exploring the effects that loan defaults have on the lead arranger's perceived reputation in the public debt markets. It has been argued in the literature that there are important "cross monitoring" benefits between various types of debt claimants. These benefits arise when the disciplinary effect and information production of a particular claimholder are valuable to other claimholders. For example, Booth (p. 27, 1992) puts forward the idea that, "the cross-monitoring hypothesis predicts that one contract may have lower monitoring costs as a result of information produced through monitoring by another claimant." Generating a sample of major loan defaults among U.S. firms between 2002 and 2010, we empirically test the effects that these loans had on the bond returns of publicly traded firms that had at the same time loans made by the same lead lender as the defaulting firm. We show that the abnormal returns of these "affected" firms are negative and statistically significant. Moreover, these abnormal returns are economically significant – with a mean about -1% when measured over an eleven day window surrounding the announcement of the defaulting loan. In addition, we find that the negative bond market reactions are particularly strong if the defaulted loan is an important deal to the lender, if it is a recently originated loan, if it comes from a relationship borrower and if the borrower has higher profitability, higher firm value and better governance at loan issuance date. These results confirm that lenders suffer a loss to their reputations when their borrowers default, and these effects are particularly pronounced in those cases where they presumably had strong incentives or they should have done a better job to monitor the defaulting firm.