"It’s Not You, It’s Them": Industry Spillovers and Loan Portfolio Optimization

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Summary

Departing from a traditional bilateral lender-borrower perspective allows to better understand how optimal loan contract terms of the marginal loan are determined by the pre-existing loan portfolio of the lender. Specifically, when exposed to competing borrowers in the same industry, the implementation of a pro-competitive growth strategy by one of the borrowers will affect industry peers to which the lender is also exposed.

How do these banks mitigate the competition spillovers to their loan portfolio?

- Extending loans with stricter covenants to the firms in such industries, curbing growth appetite and taming product market competition.
- Stricter on capital covenants, which requires borrowers to put more ‘skin-in-the-game’ and aligns equity-debt incentives.

Stricter covenants allow for increased influence over corporate policy, even well outside default states. Lenders with an industry-wide exposure will prefer to increase the strictness of contract terms over and above to induce a conservative interaction between rival borrowers.

Internalizing competition spillovers


Empirical model

Compare loan contract design from different bank-industry pairs, controlling for borrower risk and loan characteristics and accounting for unobserved time-varying heterogeneity at the bank (e.g., loan supply) or industry (e.g., industry credit demand).

\[ \text{Loan Contract Term}_{h,t,i} = \text{Lending Share}_{h,t,i} \]

+ \( \text{firm control}_{h,t-1} + \delta \text{Loan control}_{h,t,i} \)

+ \( \text{Bank} \times \text{Quarter} + \text{Industry} \times \text{Quarter} + \epsilon_{h,t,i} \)

- Lending Share (standardized): measured as dollar amount of outstanding loans extended by bank over total amount lent to the industry by all banks.
- IV Approach: Exogenous additional increase in bank lending shares derived from bank mergers.

Stricter terms to prevent competition spillovers

![Diagram](image.png)

Complementary findings

Lenders with industry-wide exposure are...

1. Stricter when industry peers to which they have exposure are closer to default (Z-score).
2. Stricter with borrowers in more mature industries, where market growth potential is lower and firm gains in market share is more likely to be detrimental to its industry peers.
3. Increased value accrues to the borrower in terms of lower debt cost and lower ‘spreads-over-strictness’ ratio (interest rate over covenant strictness). Lower industry risk (CDS Spreads).
4. Prone to include more capital-based covenants and require tangible net worth (‘skin-in-the-game’). Shorter Maturity.
5. Lenders more likely to include payout restrictions and borrowers more likely to have a capex restriction, reducing incentives for investment-based growth and the reinvestment of earnings.

Main Contribution

- I highlight the importance of lender’s pre-existing industry exposure as a determinant of the loan contract terms for the marginal loan.
- I show lenders adjust loan covenant strictness over and above to tame competition and protect other firms to which they are also exposed, maximizing the value of their debt holdings at the industry level.
- This represents an explicit channel through which lenders with an industry-wide exposure reduce product market competition.

References