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Bank loans, bonds, and information monopolies across the business cycle: test of the South African market

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2013-06-04
http://hdl.handle.net/10539/12765

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ABSTRACT

Corporate finance theory suggests that bank's private information about borrowers lets them hold up borrowers for higher interest rates and that hold up power should increase with borrower risk, and if so, banks with private information about borrowers should increase their rates in recessions more than warranted by borrower risk alone. Studies have been concluded in other markets for these propositions, particularly for the US market. This paper has replicated these studies for an emerging economy (Republic of South Africa) to see if the findings will hold across dissimilar markets. Hold up cost is not just a function of information monopoly, Rajan, 1992 posits that firms with a higher probability of failure should suffer more from informational hold-up cost. The risk of failure is more pronounced during recession than in expansion and hence relationship banks with information monopolies are able to extract more rents in recession than warranted by borrower default risk alone.

Using literature that suggest that information rents can be mitigated by multiple banking relationships, I investigated further, whether this problem of hold up cost can be mitigated through a different channel by studying credit spreads of firms that have publicly sourced funds, and continued to seek private funds in the South African market.Using LOANSPREAD as the dependent variable in a regression model, I find that loan spreads are higher for bank-dependent firms, rise in recessions and rise by a greater amount in recessions for bank-dependent firms. In the context of this study I define bank-dependent firms as those firms who have issued no public bond. The key finding is that, indeed multiple banking relationships can reduce informational monopolies, but issuing public bonds can be another channel that South African firms can use to avoid being taken advantage of by financiers with information monopoly over competing financiers.