



Firm-level Political Risk and Debt Choice

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Abstract

In this study, we examine the effect of firm-level political risk on debt financing choices. Using a sample of U.S. firms, our investigation reveals that firms with higher political risk display a stronger preference for private debt to public debt, and the magnitude of this preference varies with aggregate policy uncertainty. We hypothesize that private lenders enjoy several advantages that allow them to serve politically risky borrowers. First, private lenders can efficiently manage the reorganization process should the finalized government policy be harmful to their borrowers. Second, private lenders can gather accurate borrower-specific information to assess the impact of political risk on a borrower's creditworthiness. Lastly, there exists an implicit contract between a borrower and its relationship bank, whereby a borrower accepts less favorable terms during normal times in exchange for the bank's support during difficult times. Our empirical evidence provides support for these hypotheses. Taken together, this study advances our understanding of how cross-sectionally heterogeneous political risk influences corporate debt choice.

Introduction

- **Motivation:**
 - Recent research has shown that corporate behavior is significantly affected by uncertainty in government policy.
 - Previous researches all investigate the impacts of economy-wide policy uncertainty on corporate policies and operating environment, a recent study by Hassan, Hollander, van Lent and Tahoun (2019) stresses the importance of considering firm-level political risk.
 - Empirically, they propose a quantified firm-level political risk measure and show that over 90% of the variation of their firm-level measure cannot be accounted for by the aggregate political risk index.
- **Research questions:**
 - Does the cross-sectional difference in firm-specific political risk affect debt choice?
 - Does the cross-sectional effect of political risk on debt choice vary in a temporal fashion over a cycle of economy-wide policy uncertainty?
 - What advantages do private lenders have so they can serve politically risky borrowers?
 - How do politically risky borrowers interact with their banks over a cycle of policy uncertainty in order to receive credit support during difficult times?
- **Contribution:**
 - Examine how *firm-level* political risk affects debt financing choices.
 - Provide new evidence of how private lenders serve risky firms.

Data

- Firm-level political risk (PRisk): Hassan et al. website
- Debt choices: S&P Capital IQ database
- Financial data: Compustat

Main Results

Firm-level Political Risk and Debt Choice

DEP=	Bank loan/Total debt	Public debt/Total debt	Ln(Bank loan/Public debt)
PRisk	0.009*** (3.31)	-0009*** (-3.39)	0.058*** (3.29)
Control Variables	Y	Y	Y
Ind.& Year Effects	Y	Y	Y
Adjusted R²	0.10	0.09	0.10
N	14769	14769	14769

- A positive effect of *PRisk* on the *Bank loan/Total debt* and *Ln(Bank loan/Public debt)* but a negative effect on *Public debt/Total debt*.
- Firms with higher political risk have a higher preference for bank loan financing.

Temporal Dynamic of the Effect of Firm-level Political Risk

	Dep=Ln(Bank loan/ Public debt)
High Prisk x Pre-war Period	0.124*** (2.23)
Pre-war Period	2.332*** (14.77)
High Prisk x I{2001,2002}	0.165** (2.10)
High Prisk x I{2003}	0.115 (1.45)
High Prisk x I{2004,2005}	0.028 (0.60)
I{2001,2002}	2.341*** (14.68)
I{2003}	2.345*** (15.05)
I{2004,2005}	2.191*** (14.33)
High PRisk	0.011 (0.38)
	-0.005 (-0.15)

Advantages of Private Lenders

Reorganization Cost

- Hypothesis: The private lenders can offer attractive terms to high-*PRisk* borrowers because they can implement a low-cost reorganization process and obtain a relatively high recovery value should a borrower enter liquidation.
- Reorganization cost:
 - Probability of bankruptcy: *EDF, excessive financial leverage*
 - ☐ Captures how likely it is that a firm will enter financial distress.
 - Asset Liquidity: *PPE/A, Cyclical*
 - ☐ Estimates the recovery value creditors may claim upon liquidation.
- We find that the effect of political risk on debt choice is more pronounced for firms with higher default risk and lower potential recovery value.

Informational Risk

- Hypothesis : The private lenders have an advantage in serving politically risky borrowers because they are in a better position compared to public debt investors to gather accurate information and can therefore make informed decisions in the face of rising policy uncertainty.
- Informational Risk: discretionary accrual, abnormal real activities
 - The more manipulation activities a firm undertakes, no matter through financial or real earnings management, the less transparent and informative is its reported financial performance.
- We find the positive effect of *PRisk* is stronger for the low transparency subsample (firms with high discretionary accrual or high abnormal real activities) than for the high transparency subsample.

Bank Relationship

	Firm-level Sample	Loan-level Sample			
DEP=	Ln(Bank loan /Public debt)	Ln(Loan Spread)	Ln(Maturity)	Ln(Loan Size)	Ln (Covenant)
High Prisk x Pre-war Period x Relationship	0.708** (2.11)	-0.335* (-1.68)	0.210* (1.70)	0.365** (2.38)	-0.078 (-1.00)
High Prisk x Relationship	-0.332 (-1.1)	0.259** (2.03)	0.027 (0.39)	-0.029* (-1.89)	0.008 (1.03)
High Prisk x Pre-war Period	0.008 (0.04)	0.153 (1.33)	-0.142** (-2.05)	-0.113 (-1.13)	0.048 (1.07)
Relationship x Pre-war Period	-0.217 (-0.99)	0.278** (2.00)	-0.049 (-0.55)	-0.218** (-1.98)	-0.003 (-0.06)
High PRisk	0.072 (0.39)	-0.082 (-1.13)	-0.008 (-0.24)	-0.029 (-0.37)	-0.004 (-0.97)
Pre-war Period	3.767*** (4.95)	1.768*** (9.98)	0.311*** (3.22)	-1.529*** (-6.99)	0.166*** (2.77)
Relationship	-0.141 (-0.74)	-0.223*** (-2.79)	-0.015 (-0.36)	0.277*** (3.53)	-0.003 (-0.55)

- Hypothesis: During times of low policy uncertainty, politically risky firms are willing to accept less favorable loan terms to maintain the relationship with their banks; in return, when concerns of political risk heighten, they receive supports from their relationship banks to navigate through the difficult times.
- The coefficients of *High PRisk x Pre-war Period x Relationship* on *Ln(Bank loan/Public debt)*, *Ln(Maturity)*, and *Ln(Loan Size)* are significantly positive, but the effect of three-way interaction on *Ln(Loan Spread)* is negative.

Robustness Tests

- Effect of firm-level EPU (*PRisk*) on bank loan financing remains positive after employing various model specification, including Fama and MacBeth (1973) procedure, a change regression, and controlling for macroeconomic factors.
- The results are robust to endogeneity concerns:
 - Instrumented firm-level EPU (*PRisk*) has a positive and significant effect on bank loan, a negative effect on public debt.

Conclusion

- A positive relationship between a firm's preference for private debt issuance and its political risk.
- The private lenders' specialization in implementing efficient reorganization process, which allows them to recover a higher proportion of debt claim upon borrower insolvency.
- The private lenders' ability to gather and update information about their borrowers, which enables them to formulate timely responses to rising political risk.
- The potential long-term relationship with the borrowers, which incentivize relationship banks to tolerate short-term loss and support politically risky firms through periods of high uncertainty.