Essays in Law, Culture and Finance

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Dissertation Abstract

In this thesis, through three essays, I explore the impact of creditor rights on income inequality, corporate leverage and bank loan certification values. The three essays fall in the three distinct domains of financial economics, corporate finance and banking, respectively.

Essay 1: Creditor Rights and Income Distribution

In this essay, I argue that creditors' rights strengthening reforms lead to substitution of labor by capital due to resultant lower cost of debt finance. This change in factors of production disproportionately reduces employment opportunities for poor, unskilled workers and thus leads to higher income inequality. Using staggered D-I-D technique with country and year fixed effects on data for more than 100 countries over 25 years, I find that strengthening of creditors' rights leads to an increase in income inequality over a span of 10 years. The impact grows cumulatively over time. I find a robust evidence for the mechanism of the impact through a battery of industry level and country level tests.

Essay 2: Re-examining the relationship between creditor rights and corporate leverage through a cultural lens

Two opposing effects govern the impact of creditor rights strengthening reforms on corporate leverage. On the one hand, the income effect states that creditor rights strengthening leads to a higher supply of loans from lenders and higher debt capacity of the borrowers, which may increase corporate leverage. On the other hand, the substitution effect states that creditor rights strengthening leads to a higher threat of bankruptcy and thus may lead to lower credit demand and lower corporate leverage. Single country studies from different countries have documented contradicting results on the impact of creditor rights on firm leverage. In this multi-country study, I postulate that national culture determines risk-taking behavior of borrowers and lenders, which in turn determines whether the income effect or the substitution effect dominates in a given country. Thus I examine how culture moderates the impact of creditor rights strengthening reforms on firm leverage. I use DIDID in a generalized setting on data of over 24000 firms in 23 years from 31 countries to test our hypothesis. I find that individualism, which is associated with high risk preference, has a positive moderating effect while power distance, which is associated with low risk preference, has a negative moderating effect on the impact of creditor rights strengthening reforms on corporate leverage. We see similar results for economy-wide aggregate bank credit in the sample countries. Further, we document that firms in individualistic and low power distance countries tend to issue less equity and hold fewer cash balances in response to strong creditor rights. The results are robust to various sub-sample analysis and alternate variable definitions.

Essay 3: Creditor rights and bank loan certification values

In this paper, I study the impact of creditor rights on bank loan certification values using a large sample of 10000+ loans from 22 countries for the period of 1999-2013. I find that creditor rights increase the threat of bankruptcy and liquidation, leading to a significant reduction in loan certification values. Consistent with our hypothesis, the decline in certification value is higher for large and long maturity secured loans. Further, the reduction in certification value is less for larger, more profitable and more solvent firms. I consider three other alternative channels, viz. the lazy lender channel, the adverse selection channel and the bargaining power channel, through which creditor rights may affect bank loan certification value. But I find that, the threat of liquidation is the only dominant channel.