Dean's corner blog post

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The unintended cons of creditor rights reforms.

Creditor rights encompass the array of legal protections afforded to creditors in instances where a debtor defaults on their obligations. These rights exhibit significant variability across economies and markets. Moreover, as famously highlighted by LaPorta et al. [1997], there appears to be a positive correlation between the strength of creditor rights and both the level of economic development and the growth trajectories of different economies. Importantly, creditor rights appear to have independent real effects on growth, which are not subsumed by heterogeneity in the availability of capital assets across economies.

Hernando DeSoto eloquently conveyed this notion to the readership of the New York Times when introducing his 2000 work, "The Mystery of Capital", stating, *"most of the poor already possess the assets they need [...] But they hold these resources in defective forms [...] Because the rights to these possessions are not adequately documented, these assets cannot readily be turned into capital, cannot be traded outside of narrow local circles where people know and trust each other, cannot be used as collateral for a loan, and cannot be used as a share against an investment."* The proposed remedy? Advocate for reforms that bolster property title security, formalize business operations, and enhance the enforcement of creditor rights over titled assets.

Despite decades of reform efforts aimed at strengthening creditor rights globally, and particularly within developing economies, empirical investigations reveal substantial shortcomings concerning this De Soto-inspired initiative. For instance, findings from De Mel et al. [2013] indicate that the *demand* for titling and formalization from firms in developing economies is significantly low, raising questions about the justification for investing substantial resources in such programs. Furthermore, regulatory endeavors focused on augmenting creditor rights within developing nations have been met with unforeseen consequences, including *diminished* investment and growth in businesses (Vig [2013], Alok et al. [2022]).

What accounts for the varied effects of creditor rights across markets? In other words, what omitted variable might account for the correlation observed in the LaPorta et al. [1997] regression between creditor rights, investment, and growth? Regrettably, neither theoretical nor empirical literature has proffered a compelling resolution to this question. Theoretically, most investment models under friction posit that higher creditor rights should mitigate these frictions, thereby incentivizing investment. Empirically, uncovering quasi-experimental evidence to illuminate this inquiry proves challenging (Woodruff [2001]). Nevertheless, recent financial scholarship has leveraged within-country analyses, revealing that even within the relatively competitive US economy, enhancements to creditor rights have precipitated negative repercussions for business dynamism and startup investment (Cerqueiro et al. [2019], Ersahin et al. [2021]).

In a paper I co-authored with Dan Bernhardt and Kostas Koufopoulos, we posit that a common thread links startup financing in the US with capital raising in developing economies: a relatively *low* level of competition among potential financiers. That is, both developing regions and high-risk business lending exhibit lending markets that are lacking in depth, wherein market power is comparatively more pronounced. While this observation constitutes merely one of many distinctions between economic environments, our research substantiates the proposition that lender competition *can* significantly account for the observed heterogeneity in outcomes, contrary to prior assertions.

Our study reveals that the impact of creditor rights on real outcomes criticsally depends on the level of competition in lending markets. In contexts of high lender competition, enhanced creditor rights facilitate firms' borrowing capabilities, affirming the conventional perspective. However, we uncover a reversal of this outcome under conditions of limited market competition. In such scenarios, creditor rights become substitutes for costly entrepreneurial effort in sustaining lender profits. Consequently, monopolistic lenders may increase interest rates, which is detrimental to entrepreneurial effort, as they rely on higher creditor rights to recuperate a greater proportion of a firm's cash flows upon default. In essence, lenders may embrace higher default rates to bolster profitability during favorable states, a trade-off that undermines entrepreneurial motivation. Thus, with constrained competition, augmented creditor rights erode firm value and hinder the overall economic surplus.

Our findings impart additional complexity to the empirical discourse surrounding creditor rights reforms. Specifically, our theoretical framework reveals that higher creditor rights can impair firms subject to limited lender competition, *even when* the interest rates on their debts *decline* post-reform. In this context, firm value diminishes, despite lower interest rates, driven by creditor rights' potential to increase lender losses given default. Consequently, our work raises skepticism regarding the reliance on interest rates (or nominal values) as indicators in assessing the real impacts of creditor rights reforms, a common practice in empirical research.

In conclusion, our paper elucidates the profound interconnection between creditor rights and competition regulation, underscoring that reforms aimed at enhancing creditor rights may yield disparate outcomes contingent upon the competitiveness of the financial market in question. For the De Soto agenda to advance meaningfully, we advocate that policymakers and scholars meticulously evaluate the financial market landscape in which creditors operate, particularly concerning the assurance of effective competition. Absent a focus on competition, we contend that endeavors to enhance titling, formalization, and creditor rights are unlikely to yield cost-effective results and may even incite counterproductive outcomes.

Unfortunately, another implication of our analysis is that lenders have an incentive to advocate for greater creditor rights particularly when financial market competition is low, and hence they can appropriate a greater chunk of the proceeds from a creditor rights reform. In the limit, when markets are perfectly competitive, lenders do not care at all about the level of creditor rights, as they expect to make zero abnormal profits anyhow. Therefore, there seem to be a trade-off between the positive economic effects from increasing creditor rights, and the creation of a political consensus behind a creditor rights reform. We suggest that further research explores the relation between financial market competition and creditor rights, as well as the conditions required for a successful regulatory effort around creditor rights to take place.

References

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