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The choice among bank debt, non-bank private debt, and public debt: evidence from new corporate borrowings☆

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Abstract

Using a sample of 1,560 new debt financings, we examine the choice among bank debt, non-bank private debt, and public debt. The primary determinant of the debt source is the credit quality of the issuer. Firms with the highest credit quality borrow from public sources, firms with medium credit quality borrow from banks, and firms with the lowest credit quality borrow from non-bank private lenders. Non-bank private debt thus plays a unique role in accommodating the financing needs of firms with low credit quality. In addition, the choice of debt source is (weakly) influenced by managerial discretion.

JEL classification: G32; G33

Keywords: Banks; Private debt; Public debt; Debt policy

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1. Introduction

Flow of funds data from the Federal Reserve System indicate that net new issues of equity have been negligible over the past two decades.[1] In other words, debt financing is the predominant source of new external funds for US corporations. New debt financing comes from three primary sources: banks, non-bank private lenders, and public debt offers. We provide evidence on the choice among these alternative sources of debt financing.

Previous studies hypothesize that private debt financing has a significant advantage over public debt in terms of monitoring efficiency (e.g., Diamond, 1984; Boyd and Prescott, 1986; Berlin and Loyes, 1988), access to private information (Fama, 1985), and the efficiency of liquidation and renegotiation in financial distress (Chemmanur and Fulghieri, 1994; Gertner and Scharfstein, 1991). However, Rajan (1992) argues that private lenders can also negatively affect the borrower by extracting rents and distorting management incentives.

Prior empirical studies by Houston and James (1996), Johnson (1997), Krishnaswami et al. (1999), and Cantillo and Wright (2000) document a positive relation between the use of public debt financing and firm characteristics such as size, leverage, age, and amount issued. However, these studies differ in their findings about the effects of the market-to-book ratio and the proportion of fixed assets to total assets on the source of debt.

We extend the literature on debt choice in several ways. First, we use an incremental approach that analyzes the determinants of new debt issues.[2] The incremental approach allows us to link the borrowing decisions of the firm with variables measured just prior to the borrowing decision; to investigate the borrowing decisions of firms that have no debt outstanding at the time of issuance; and to compare the characteristics of different types of debt financing. On the other hand, although the incremental approach is well suited to testing theories that rely on time-variation in firm characteristics, it is not as well suited to testing theories that relate the mix of debt to the firm's asset mix. Moreover, an incremental borrowing decision might represent a temporary deviation from the firm's optimal mix of debt claims. For these reasons, our findings should be viewed as complementing those from studies of the existing mix of debt claims.

Second, unlike most prior studies, our empirical analysis distinguishes between bank and non-bank private debt. This distinction is important since we show that non-bank private debt is an economically important financing source. Moreover, non-bank private loans exhibit substantially different characteristics than bank loans.

Third, we provide direct evidence on the role of credit quality in the choice of debt source. Several theoretical studies predict an association between credit quality and

[1] See Board of Governors of the Federal Reserve System (2000).

[2] A similar incremental approach is used by Hovakimian et al. (2001), who study the debt–equity choice; by Jung et al. (1995), who examine external financing decisions; and by Guedes and Opler (1996), who study the determinants of debt maturity.