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Do hedge funds trade on private information? Evidence from syndicated lending and short-selling ☆

Nadia Massoud [a,*], Debarshi Nandy [a], Anthony Saunders [b], Keke Song [c]

[a] York University, Schulich School of Business, Canada
[b] New York University, Stern School of Business, USA
[c] Dalhousie University, School of Business Administration, Canada

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ABSTRACT

This paper investigates an important contemporary issue relating to the involvement of hedge funds in the syndicated loan market. In particular, we investigate the potential conflicts of interest that arise when hedge funds make syndicated loans and take short positions in the equity of borrowing firms. We find evidence consistent with the short-selling of the equity of the hedge fund borrowers prior to public announcements of both loan originations and loan amendments. We also find that hedge funds are more likely to lend to highly leveraged, lower credit quality firms, where access to private information is potentially the most valuable and where trading on such information could lead to enhanced profits. Overall, our results have important implications for the current debate regarding regulating the hedge fund industry.

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1. Introduction

Over the past decade, hedge funds have made significant inroads into the syndicated loan market. In particular, anecdotal evidence suggests that hedge funds are willing to lend to borrowers that commercial banks could be unwilling to lend to. In 2005, hedge funds and other institutional investors provided almost 50% of the $509 billion loans made in the highly leveraged segment of the syndicated loan market. Sufi (2009) argues that the introduction of loan ratings in 1995 allowed nonbank institutional investors, such as hedge funds, to enter the syndicated loan market, which otherwise had been dominated by commercial banks. The entry of hedge funds into this market thus raises a number of important questions and issues that so far have not been addressed. In particular, we investigate the conflict of interest that arises when hedge funds participate in syndicated lending, while at the same time shorting the stocks of borrowing firms. This issue is especially pertinent because hedge fund lenders, like banks, are quasi-insiders and thus privy to private information about the performance of borrowing firms around both loan originations and loan renegotiations.[1] However,

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* Corresponding author.
E-mail address: nmassoud@schulich.yorku.ca (N. Massoud).

[1] See Dennis and Mullineaux (2000) and Sufi (2007) who establish that the origination and maintenance of syndicate loans depend crucially on borrowers providing lenders with updated confidential information. Thus, syndicate participants in loans of publicly traded firms routinely have access to material nonpublic information prior to it being revealed to the public markets.

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hedge funds are not subject to the same degree of oversight and regulation as banks.

Public concerns recently have emerged about hedge fund involvement in corporate lending. An article in the October 31, 2005 issue of Business Week voiced these apprehensions: "[A] new breed of lender is stepping in: Hedge funds are providing hundreds of millions of dollars to companies whose shaky credit disqualifies them for prime bank loans. ………But with the new source of capital come new dangers, including the possibility that hedge funds will make risky loans and exploit information gained as lenders to benefit their trading gambits." These concerns are consistent with the recognized difference between the objectives and expertise of hedge funds and traditional lenders such as commercial banks (see, for example, Diamond, 1984; Fama, 1985). Specifically, hedge funds could seek to maximize short-term profits, while commercial banks may seek to maximize long term profits by building customer relationships over time. Prior research has shown strong support for the importance of banking relationships. What has not been established is whether, or how, hedge fund lenders are different from bank lenders, especially in protecting their clients' interests. In this paper we investigate the potential conflict of interest that arises when hedge funds participate in syndicated lending. In particular, we analyze two cases: conflicts that could arise at loan origination and conflicts that could arise around loan amendments.

Empirical evidence supports the view that the announcement effect of hedge fund loan borrowers is significantly negative compared with that of bank borrowers. During the period 2005 to 2007, we found that the market reacted positively to new bank loan announcements with a cumulative abnormal return of 1.52% during a (0, 5) day window (significant at 5%), while the market reacted negatively to announcements of new hedge fund loans with a cumulative abnormal return of −1.29% during a (0, 5) day window (significant at 10%).[2] Thus, one potential profitable strategy is to short-sell the equity of a borrower prior to a new loan announcement by taking advantage of the private information gathered during the lending decision process. We investigate this potential conflict of interest by analyzing the short-selling of a hedge fund borrower's equity prior to loan announcements benchmarked against the short-selling of a borrower's equity around commercial bank loan announcements. Because regulation could prevent banks from directly engaging in trading on the equity of the borrower (except under certain special circumstances), we conduct various robustness checks of our results by comparing the short-selling by hedge funds to several alternative benchmarks with potentially lower regulatory barriers, finding similar results. Overall, our results are consistent with the notion that the equity of the hedge fund borrowers is short-sold prior to public announcements of loan originations.

We also analyze the potential conflicts of interest that arise at the time of loan amendments. It is well known that lenders often enforce very strict covenants on the loans they grant to financially troubled firms (see Drucker and Puri, 2009) and failure to comply with these covenants results in a technical default. As a result, such violations give lenders the right to reevaluate the financial position of a borrower and decide whether or not to amend an existing loan contract. Nini, Smith, and Sufi (2009) find that such violations allow creditors to introduce several restrictions in subsequently renegotiated loan agreements. Thus, following a covenant violation, a restructured loan could include new capital expenditure restrictions, increasing or decreasing the loan interest rate, the loan's maturity, or the principal amount. During this process of renegotiation, lenders could obtain new or additional private information about the future performance of a borrower. Thus, a potential conflict of interest arises when hedge fund lenders take advantage of this private information and trade on it by short-selling the equity of borrowers prior to loan amendments dates.[3]

While we do not differentiate between active and passive hedge fund lenders, it could be argued that active hedge fund lenders, in certain situations, force such amendments, thus gaining control over the timing and severity of the amendments process. This not only implies a greater potential conflict of interest but also enables the hedge fund lenders to generate potentially larger profits by trading on private information. For example, such an issue arose in March 2006 when Movie Gallery, a large movie rental chain, breached covenants and requested amendments to its existing loan, which was syndicated by hedge fund lenders. On March 6, 2006, executives from Movie Gallery held a private conference call for their lenders to discuss the fact that industry conditions primarily had caused the company to recognize a record loss of $522 million. These losses violated one of the major covenants of a $1.35 billion syndicated loan extended by hedge fund lenders such as Highland Capital Management, Canyon Capital, and Silver Point Capital. The Movie Gallery executives requested that their lenders amend the existing loan contracts and relax the existing financial covenants. Nearly two weeks after the private conference call, on March 17, 2006, Movie Gallery publicly announced its loan covenant amendments. However, between the conference call on March 6 and the announcement on March 17, short-selling of Movie Gallery's stock rose significantly. In particular, between March 7 and 13, the weekly cumulative short-sale volume increased from 0.4 million shares (1.23% of the outstanding shares) to 3.04 million shares (9.5% of the outstanding shares). By March 13, Movie Gallery's stock price had fallen by 61% as its closing price dropped from

[2] Due to space considerations, we do not present the detailed results for these event studies. They are available upon request.

[3] While hedge funds can take advantage of such private information in other markets, such as the credit default swap (CDS) market or the option market, in this paper we primarily focus on the equity market and on short-selling, due to data availability and data quality issues. For example, in the Movie Gallery case, even though Movie Gallery had CDS that were trading at the time, the data are largely missing around the loan amendment dates. Note that we do not analyze covenant violations per se. We simply analyze the trading pattern around loan amendment announcement dates irrespective of whether there has been any covenant violation.

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