Lingnan University 嶺南大學 香港 Hong Kong

Department of Economics

Research Findings Seminar

"CEO Characters and Loan Contracting"

(in English)

Presenter:	**Mr MA Yiu-chung, Arbitor (PhD Student)**
Date:	10 April 2017 (Monday)
Time:	10:30 – 11:30 am
Venue:	WYL314, Dorothy Y. L. Wong Building
Chief Supervisor:	Prof. Thomas J. VOON (Associate Professor)
Co-supervisors:	Prof. WONG Ho-lun, Alex (Assistant Professor)

Abstract

The first part of the thesis investigates the relationship between managerial overconfidence and loan covenant usage. Empirical finding shows that creditors significantly use more covenants; increase covenant intensity; use financial and general covenants; use performance-based and capital-based covenants; and rely on different types of covenants such as debt to cash flow, coverage ratio, net worth, debt to balance sheet and liquidity covenants to curb the default risk emanating from managerial overconfidence. Besides, creditors tighten individual covenants such as debt to cash flow covenant and current ratio covenant in order to alleviate their risk exposure. Covenant usage is reported to be quantitatively larger in the loan contracts of firms with higher market-to-book ratios, reflecting that high-growth firms provide the opportunities for overconfident CEOs to invest more intensively. To address endogeneity and self-selection, the research employs a natural experiment with Sarbanes Oxley Acts (SOX) implemented in 2002 and beyond significantly drives the overconfidence-covenant relation. In addition, the research also employs change in change method, the finding shows that a change in CEO overconfidence due to a change in CEO employment leads to a significant change in covenant usage.

The second part investigates the interaction of firm's CEO compensation and overconfidence for banks to assess credit risk. The empirical result suggests that covenant restrictions imposed by the creditors increase with CEO's holding of option compensation but decreases with CEO's holding of stock compensation. Option compensation and CEO overconfidence interact to accentuate the usage of financial covenants. The results also suggest that option compensation and CEO overconfidence significantly increase credit risk but mainly in young, high-growth, or high-risk firms. In addition to imposing covenants, banks use other loan contract terms such as shortening debt maturity, increasing loan spread and tightening specific covenant types. However, these different contract terms could not replace covenant usage, pointing to the crucial importance of using financial covenants to curb overconfidence/incentive risks.

ALL ARE WELCOME

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