Bankruptcy & Moral Hazard:

Lender Approaches to Possible Default

“Hard” Approach:

- Lender is committed to imposing bankruptcy & liquidation
- dispersion of debtor’s unsecured assets to control of trustee

Cons: Collateral is worth less to lender, enforcement costs are high,

“Soft” Approach:

- Lender may renegotiate debt structure of loan contract

Cons: Prospect of a renegotiation safety net may decentivize borrower effort in project success

Types of Bankruptcies

Chapter 7:

- “Liquidation Bankruptcy”
- Places a temporary stay on current debts
- Selling of “nonexempt” assets to repay creditors

Chapter 11:

- Allows debtors engaged in business to continue operating & avoid liquidation
- Seek debt adjustments by reorganizing debt structure (time, interest rates, etc.)

Chapter 13:

- a.k.a. “wage earner’s plan”
- Individual debtors may propose an adjusted repayment plan to creditors
- Time frame of 3 to 5 years

Borrower Protections

- Safety nets provided by soft approach:
  - extending repayment time
  - reducing interest rate
  - partial debt forgiveness
- Investment project outcome only costlessly observable to borrower
- After a loan is accepted at a given interest rate, lender enforcement becomes difficult until the project outcome is realized

(Covitz & Heitfied, 1999)

Lender Protections

- Collateralized contracts
- U.S. Bankruptcy Code provides lenders w/ flexibility in how strictly they choose to enforce the contracts they write
- Internal rating systems used to determine a loan's "stock-of-risk" based on loan term, loan size, borrower's past, etc.

Literature Review

1.) Janda, K. (2004, Feb.). *Bankruptcy Procedures with Ex Post Moral Hazard*. Charles University in Prague.

- Most default situations are met with “soft” budget approaches from lenders
- Renegotiation tends to be more beneficial to both borrower & lender
- There is a possibility that otherwise successful borrowers may willfully default

2.) Carroll, J. & McCann F. (2017, April 20). *SME Collateral: risky borrowers or risky behaviour?* Central Bank of Ireland.

- “no evidence that collateral is a successful tool for mitigating against borrower missed payments” (pg. 3)
- Collateral is more effective in reducing expected losses from a default, rather than discouraging the risky behavior that leads to default

Intuition of Moral Hazard in Loan Contracts

- Widespread “soft approach” use by lenders
  - lenders are more likely to renegotiate to better repayment terms to avoid bankruptcy costs
  - if borrowers are are aware of this, they may make riskier investments or willfully default b/c they know there’s a safety net

- Collateral is **not** an effective deterrent to risky behavior
  - this means most of the enforcement policies are now only available post-project outcome

- Borrower’s have private knowledge of their project’s outcome first
  - they may choose to not report project failure to the lender
  - they may choose to not report project success, and willfully default to obtain better repayment options