The Decline in Secured Debt

Posted by Efraim Benmelech (Northwestern University), Nitish Kumar (University of Florida), and Raghuram G. Rajan (University of Chicago), on Monday, January 27, 2020

Editor's note: Efraim Benmelech is the Harold L. Stuart Professor of Finance at the Kellogg School of Management at Northwestern University; Nitish Kumar is an Assistant Professor of Finance at the University of Florida Warrington College of Business; and Raghuram Rajan is the Katherine Dusak Miller Distinguished Service Professor of Finance at the University of Chicago Booth School of Business. This post is based on their recent paper.

What role does collateral play in corporate borrowing? At one level, the answer is straightforward. Collateral consists of hard assets, which are not subject to asymmetric valuations in markets and which the borrower cannot alter easily. Collateral gives comfort to a lender that even if she does little to monitor the borrower's activity, and even if a borrower's cash flow proves inadequate to service the debt, the lender's claim is protected by underlying value. An extensive theoretical literature spanning law, economics, and finance shows that collateral protects the lender's claim against strategic default by the borrower and alleviates financial frictions stemming from borrower moral hazard and adverse selection. In addition, some have suggested that collateral is an effective way of protecting debt against subsequent dilution by the debtor. When an effective system of seniority of claims is not available, creditors who register the collateral backing their debt with a collateral registry effectively establish the seniority of their debt claim, at least up to the value of that collateral.

Given these stated rationales for the virtues of secured debt, in the first part of our paper, The Decline of Secured Debt, we study secured debt issuance by U.S. corporations over more than a century—from 1900 to 2017. Using data on bond issuance and on corporate balance sheets from a variety of overlapping datasets, we document that the issuance of secured debt has declined dramatically. Almost all debt issued during the early twentieth century was backed by collateral. For example, secured bonds accounted for 98.5% of total bond issuance in 1900. By 1943, the share of secured bonds declined to 66.0%. The use of secured debt continued to decline, and in the 1970s only half of bonds issued were secured. By 2007, the median firm's secured debt amounted to only 13% of its outstanding debt. Since the Great Recession, the share of secured debt has hovered around 15%. Superimposed on this trend, we find a strong countercyclical component to the issuance of secured debt, with corporations more willing or compelled to issue it in the trough rather than peak of a cycle. The issuance of secured debt has increased slightly in recent years, but it is too early to tell how much of this is a reversal of the previous trend and how much of it is cyclical.

What has led to the decline in the use of secured debt by U.S. corporations, despite its seeming theoretical merits? In the second part of the paper, we go deeper into the theoretical rationales for (and against) the use of secured debt, and draw from these, as well as the evidence, to provide explanations. We organize our explanations along two dimensions: (i) creditors' declining demand for security and (ii) debtors' increasing unwillingness or inability to supply collateral. Creditors' declining demand for security relates to the increasing tolerance of creditors to leaving their claims unsecured. Similarly, debtors' might see costs associated with pledging assets, and these may have become more salient over time. Of course, both demand and supply are important for determining the equilibrium quantity of secured debt.

Let us be more specific, starting with declining creditors' demand for security. We argue that early in the 20th century, lenders demanded collateral to protect themselves against the risks that borrower actions such as tunneling out corporate cash flows or selling assets to related parties would leave them with little means of recovery conditional on borrower default. Even when corporate bankruptcy legislation was initially passed, the priority of unsecured debt vis a vis equity was not fully respected, which enhanced the attractiveness of collateral for creditors. As accounting improved and gave lenders more confidence in the reliability of reported cash flows, as stronger corporate governance protected firm cash flows and assets from being tunneled out to related parties, and as effective bankruptcy legislation gave lenders more confidence that the priority of debt versus equity would be respected, lenders no longer needed collateral to protect their claims against management or equity.

Financial development may therefore have reduced the need for lenders to take collateral in the normal course from established borrowers to protect themselves against the threat of being dispossessed by borrower malfeasance. Instead, collateral's main function may have changed to prioritizing the value of a secured lender's claims against other creditors in bankruptcy. With collateral now performing a more modest function, other issues probably came to the fore to continue the decline of the use of secured financing.

From the borrower's side, pledging assets up front is costly. Borrowers may be interested in having more financial flexibility by preserving collateral capacity, giving it up only when necessary to unlock access to further borrowing. In addition, firms might want to avoid issuing secured debt to maintain operational flexibility. By pledging collateral, a firm limits its flexibility to sell or redeploy assets to craft a better business operation. While presumably creditors might be willing to accept contractual modifications to permit value enhancing redeployment, the process of making such modifications might take time, and creditors may extract rents from the borrower in return for flexibility.

With healthy firms incurring costs in pledging collateral, and with collateral helping lenders only closer to financial distress, borrowers would have become more inclined to issue collateralized debt only contingent on likely distress. Legal developments such as negative pledge clauses, coupled with better information about firm borrowing, would have given creditors the confidence to stay unsecured until they sensed impending borrower distress. Such developments might explain both the continuing secular decline in the issuance of secured debt through the century, even after accounting improved and bankruptcy legislation developed, as well as its use primarily when a firm's risk of financial distress increased, or in business cycle downturns. In our companion paper, Secured Credit Spreads, we show that lenders are unwilling to accept lower credit spreads for secured debt relative to unsecured debt when a firm is healthy, but are willing to accept significantly lower credit spreads when the firm's credit quality deteriorates, or when the economy slows, or when average credit spreads widen. In short, we argue that the development of U.S. capital markets, as well as the institutions that support such markets, have enabled modern U.S. firms to offer collateral on a more contingent basis—as they near financial distress—

thus allowing firms to retain financial and operational flexibility in normal times while reassuring creditors their priority will be respected.

Finally, it is not just the business environment that has changed, firms have also changed. Assets traditionally used to collateralize debt such as property, plant, and equipment have declined as a fraction of the value of firm assets, while more “intangible” assets, normally thought of as hard to use as collateral, such as brand names and patents have increased. The decline in secured debt issuance towards the end of the last century probably is related to the decline in asset tangibility. However, contractual innovations in this century now allow firms to secure a greater variety of assets, including intellectual property, more easily, and have reduced the transactions costs associated with pledging intangible assets. Although it is too early to tell whether secured debt is being resurrected with these new assets serving as collateral, we cannot rule out this possibility. This paper should certainly not be construed as an obituary.

The complete paper is available for download here.