Misallocation due to inefficient exits– Evidence from India

By Nirupama Kulkarni

Discussed by:
Abhiroop Mukherjee

Summary

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- Problems in enforcing creditor rights are an important barrier to creative destruction
  - Improvement in creditor rights leads to credit being allocated from unprofitable to profitable borrowers
- Paper exploits changes in creditor rights due to SARFAESI Act 2002
  - The Act made it easier for lenders to directly seize defaulters' assets circumventing lengthy legal delays

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- After the passage of the law banks cut credit to low quality firms, and increased credit to high quality firms
- Related to Vig (JF 2013):
  - SARFAESI led to reductions in secured debt
  - Strengthening of creditor rights introduced a liquidation bias and led firms to alter their debt structures to contract around it.

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- Such reallocation had real effects:
- Evidence consistent with low quality borrowers cutting back capital expenditure and employment because of this
  - Low quality firms tightened up their operations after the passage of the law
  - Births of more firms in hitherto zombie-dominated industries

Summary

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- Interesting paper, first order issue
  - Carefully and clearly written, although an early draft
  - Commendable data work to merge many different data sources to buttress evidence
    - Brings in very nice new details not available in prowess, like the fact that bad firms reduce "non-core" operations to tighten up
  - Detailed empirical analysis
  - Thought through many potential issues

Thoughts

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- **Identification- I:**

- Identifying assumption in this paper is that absent SARFAESI, low- and high-quality borrowers debt etc. would have trended similarly.

    - Not completely convincing. SARFAESI is just a pre-/post-2002 thing in your current set-up. Need variation to exposure to the Act to interpret things

Thoughts

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- **Identification- I:**

  - "Quality" here is measured in terms of profitability/leverage.

  - In general, competition was increasing in India throughout this period, so it is unclear to me that unprofitable firms would not have had a tough time even if SARFAESI was never enacted

  - Any change in India around the time which made life harder for the zombies could otherwise explain results
    - One way to check: replace post 2002 with post 2004: anything different?

  - Particularly problematic for "real effects" results: difficult to think unprofitable firms would have continued as is in the face of stronger competition

Thoughts

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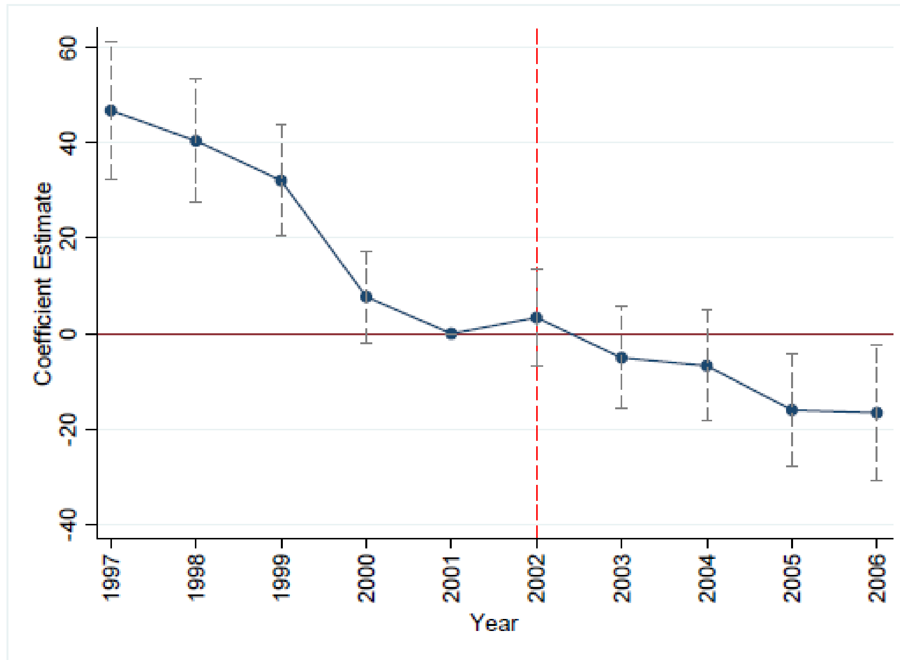
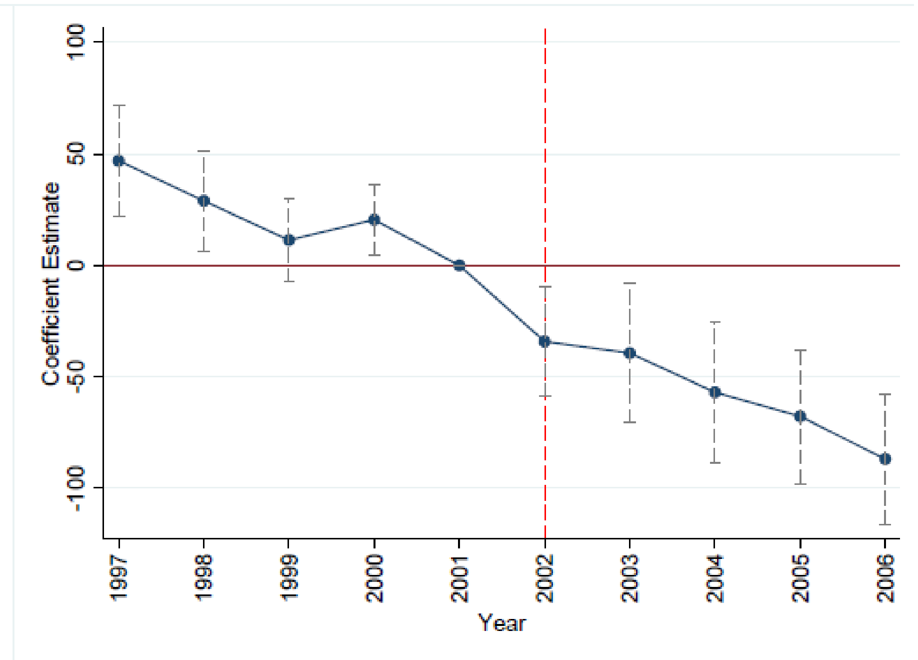
•Identification- I:

- Particularly problematic for "real effects" results: difficult to think unprofitable firms would have continued as is in the face of stronger competition



(a) **CapEx**



(b) **Employment**

Thoughts

- **Identification- I: Suggestion:**

- Follow Vikrant's strategy: use interactions of firm quality with tangibility cuts everywhere

  - less worrying if you can show that unprofitable firms were cutting non-core projects, winding down operations etc only if they had high tangibility

  - Basically, link SARFAESI directly to your real outcomes through the collateralizable asset, i.e., tangibility channel.

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- **Identification- II:**

- Paper measures "quality"/ "zombie" status based on interest coverage (IC)

  - But interest coverage is not just a measure of quality/profitability, but also a function of leverage, which is an important policy choice variable for most firms

  - A firm can change its interest coverage by choosing to be less levered, making IC – and hence "quality" an endogenous variable

  - So even if the law change is plausibly exogenous, one component of the interaction effect you are studying is likely endogenous.

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- **Identification- II:**

- Think about the specification:

$$y_{it} = \alpha_i + \gamma_t + \eta \times \mathbb{1}_{Post} \times \mathbb{1}_{(LowQ)} + \beta \times X_{it} + \epsilon_{ijt}$$

  - Main issue in specifying the setup the existing way is that the treatment/control groups – which measure differential exposure to SARFAESI for different firms are endogenous.

  - On example why this is problematic: during the time SARFAESI legislation was being discussed, firms could have changed their exposure to the law if exposure was endogenous

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•Identification- II:

• The relation between leverage and interest coverage also makes some results difficult to interpret:

•Example–
Transition from 'zombie' to 'non-zombie':
You show that zombies are forced to reduce leverage post SARFAESI. This would result in forced lower interest expense to service the new low leverage.

– can become a non-zombie automatically, given definition? So, the fact that zombies are more likely to become non-zombies post SARFAESI just follows mechanically from your first result.

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- **Identification- II: Suggestion**

- Why not use a measure of profitability or stock returns, not intermediated by leverage?

  - Maybe use some criteria based on industry-size-age adjusted profitability?

  - Works under the assumption that firms try to maximize profits throughout: SARFAESI or not

  - Ideally it would be great to see some examples of industries suffering from profitability shocks due to, for example, obsolescence (35mm films & Kodak? Jute technology in Bengal?)

Thoughts

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- **Theory: Equilibrium**

- After SARFAESI low quality borrowers would pre-emptively reduce borrowing rather than borrow and risk default and asset seizure

  - But many models of collateral suggest that lenders are asymmetrically informed about collateral values

- So, would this not make firms with "good" collateral withdraw, and burden banks with the "bad collateral" firms on their balance sheets?

  - What prevents this?

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- Other:
  - Paper right now is a bit too long, and lacks focus.
  - Trim some of the analyses.
    - Do you really need to analyze unprofitable firms and zombie firms separately?
    - Given the coarseness in measuring bank-firm paired lending, how much value is the bank exposure section adding?
    - Discussion on why you are writing a paper on SARFAESI in spite of the general notion that SARFAESI didn't solve the problem it was supposed to: Appendix, if at all
  - Bring up some of the discussion: DRT is a nice way of showing (some) external validity.

Conclusion

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- Interesting paper on an important topic
    - Recommend reading because I enjoyed it

Thank you!