Rational Anchoring: The Impact of Borrowing History on Debt Contracting

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Abstract:

This paper studies the rational anchoring effect in the credit market. I find that a firm's historical cost asymmetrically affects its current loan cost. When the average credit spread has fallen since the firm's last borrowing, banks anchor to the previously high cost and charge more than those justified by the firm fundamentals. However, when the average credit spread has risen since the firm's last borrowing, the firm's loan cost is not affected by its borrowing history. The current cost does not anchor to the firm's previous low cost, and the firm does not pay less than it should pay. The asymmetric anchoring effect on the current loan cost also holds at the firm level. This finding suggests that banks strategically refer to the previous high spreads in loan pricing. Further analyses show that the relationship becomes stronger when banks have more information advantage and when firms are more bank dependent. Overall, the result suggests that the observed anchoring behavior in the financial market can also be rational and strategic.

JEL Classification: G32; G41

Keywords:

Rational Anchoring; Loan Contracting; Bargaining Power; Information Monopoly.