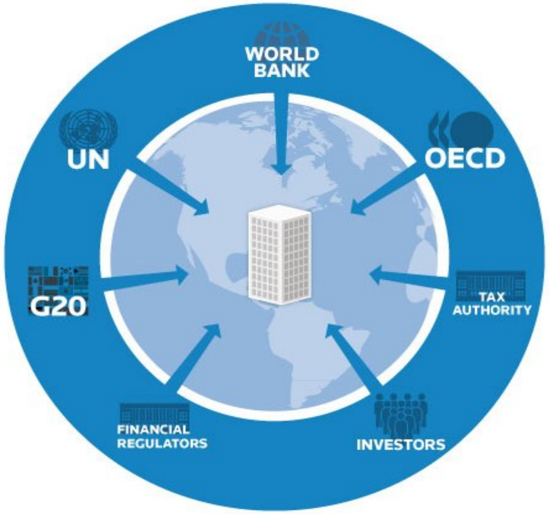
Bank Monitoring and Corporate Tax Planning

Lin, Xin, Zhang and Zhang (2017)

Discussion by Dushyant Vyas,
ABFER Singapore April 2017

Why is this important?

- Economically important?
  - OECD estimate – governments lose approx. $240 bn due to corporate tax avoidance
- Regulatory scrutiny
  - Example, EU's attempt to recoup taxes from Apple
  - Continuing attempts by OECD



Optics matter?

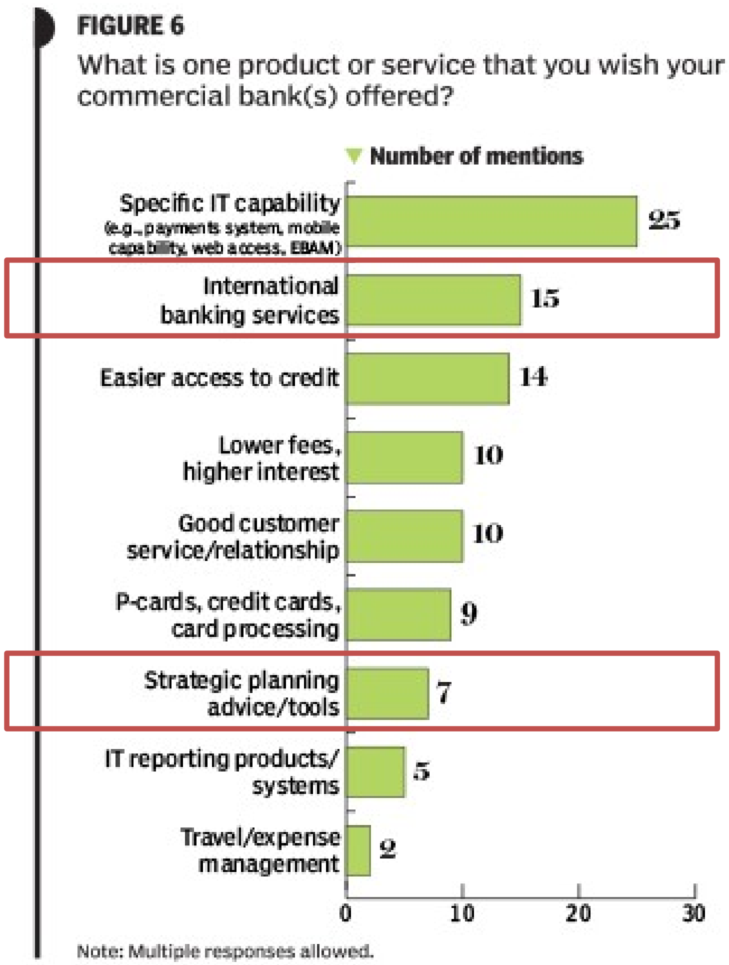
- Recent media accounts: tax avoidance is increasingly viewed as risky
- Reputational risk: Investors have taken notice?

"It is quite clear to companies and to the investor community in general that aggressive tax planning belongs to the past…. It will damage them in the long run much more than they think…..I don't think this is the music that society wants to dance to any more."

Sasja Beslik, head of sustainable finance at Nordea Asset Management

Financial Times, Oct 28 2016; retrieved May 13 2017

Banks as strategic partners?



- Borrowers seem to value banks not only for access to credit but also for aspects such as international banking services and strategic planning and advice (possibly includes facilitation of tax planning strategies?)

- Survey of 600 senior finance executives conducted by CFO.com (*2014 CFO Commercial Banking Survey*)

Banks as tax intermediaries

- Anecdotal evidence suggests that banks often design complex financial instruments/structures that help in tax avoidance. E.g., Deutsche Bank pitched such products to many of its clients (Financial Times, Nov 29 2015)

Deutsche Bank

Deutsche Bank created complex tax avoidance strategies

NOVEMBER 29, 2015 by: Gina Chon in Washington and Joe Leahy in São Paulo

Deutsche Bank has been devising complex international tax avoidance strategies for some of its largest corporate clients, even as G20 governments and the OECD attempt to close loopholes involving moving money to other jurisdictions.

UBS

UBS faces tax evasion trial in France after settlement talks fail

Swiss bank believes €1.1bn fine suggested by French prosecutors is too high

© Reuters

MARCH 20, 2017 by: **Jennifer Thompson**, **Ralph Atkins** and **Michael Stothard**

UBS faces criminal trial in France after failing to agree a settlement with prosecutors over allegations it helped wealthy clients to evade tax authorities.

Banks as tax intermediaries

- Recent academic interest:
  - Gallenmore, Gipper, and Maydew (2016) – large scale empirical evidence documenting that banks facilitate tax planning for their clients
  - **Lin et al. 2017** and Wan and Zhao 2017 – bank monitoring during covenant violations enables tax avoidance

LXZZ – causal arguments

Series of specific causal arguments:

1. Lenders gain control rights upon borrower violation of loan covenants
2. Bank monitoring intensifies after they gain control
3. Bank monitoring reduces managerial agency costs (and thus the managerial tendency to extract rent and obfuscate using tax avoidance)
4. As the cost of tax avoidance goes down, more tax avoidance is observed upon violation

Strengths

Valiant casual inference attempts

1. Regression discontinuity design
2. Series of robustness tests
3. Cross-sectional tests (e.g., presence of large shareholders)

Incredible amount of data work – multiple datasets and samples

Comments

1. Mechanism
2. Financial distress
3. Regression discontinuity design

Mechanism

- Finding of decline in tax rates post violation is not new. In addition to the recent papers, evidence dates back to Sweeney 1994 (Table 1)

	Year relative to debt-covenant violation							
	− 5	− 4	− 3	− 2	− 1	0	+ 1	+ 2
Panel A: Violation sample								
Sales growth	13.3%	11.0	11.8	7.6	4.6	− 9.2	− 8.8	0.4
Operating profit margin[a]	7.1%	7.1	5.4	3.7	1.5	− 2.6	0.3	3.5
Extraordinary items/Sales	0.0%	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Discontinued operations/ Sales	0.0%	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Net earnings margin[a]	3.7%	3.3	2.6	0.8	− 0.7	− 9.0	− 3.7	0.5
Total debt/Total assets	57%	58	58	60	65	73	75	71
Tax rate[a]	31%	32	19	10	0	0	0	0
Net sales ($ millions)	61	66	82	93	96	89	78	80
Total assets ($ millions)	42	45	53	57	61	55	47	46
Number of observations	130	130	130	130	130	121	91	78

- Question – what explains the decline?

Mechanism

How do lenders abet tax avoidance?

Is it monitoring, advising, or forcing the client to buy specific products?

- Anecdotal evidence & Gallenmore et al. 2016 suggest a facilitating role: This is plausible given media and regulatory accounts
- LXZZ suggest that intensified bank monitoring post violation reduces the agency costs of tax avoidance: Argument rests on a series of assumptions

Mechanism

Bank monitoring

- Perhaps too indirect
- Do all covenant violations result in intensified bank monitoring? (more on the next slide)
- Not clear how increase in bank monitoring can alter the perception of tax planning as being risky – could it be the opposite given recent anecdotal evidence concerning banks?

Mechanism

Indirect (behind the scenes) influence: depends upon bank response to violation

- Is violation waived or is the loan called/accelerated?
- Unconditional waiver
- Conditional waivers
  - (hefty?) legal and admin fees
  - Change in loan terms including increase in interest rates, more restrictive covenants, collateralization, etc.
- Restructuring: Operational and financial restructuring (including changes that directly or indirectly impact taxes): Deleveraging; Investment policy (and asset sales); Board representation; Management turnover; Downsizing / employee layoffs

Suggestion: delineate the channels through which banks influence ETR

- **Facilitating tax planning strategies:** e.g., offering structured financial products that are tax advantageous (search media reports for banks that engage in such activity?)
- **Corporate governance:** Violation changes the extent of creditor influence on management (examine appointment of CRO; subsamples with variation in post-covenant lender monitoring -- e.g., board of director changes, management turnover)
- **Financial constraints:** Other costs of default such as change in loan terms can pressurize management to pursue tax avoidance strategies to avoid future defaults (examine observed changes in loan terms)
- **Indirect reputational costs – product market:** tax planning could be a result of need to "save face" in the product market (borrowers in competitive industries?)

Financing constraints: Discontinuity at the breach threshold?

- Lenders often impose **punitive interest costs and fees in exchange of waiver**, exacerbating financial distress just beyond the breach threshold
- Prior research suggests that borrowers undertake income increasing activities to avoid covenant breaches – those that **just violate are likely to have exhausted such opportunities and are potentially in deeper distress that those who avoided the breach**
- Firms in financial distress are more incentive to pursue tax saving strategies (Edwards et al. 2016)
- Negligible tax paid at very low levels of pre-tax income (consistent with Sweeney 1994?)
- **Suggestions:**
  - **Control for discontinuity in pre-tax income, cash reserves, etc.**
  - **Exclude observation with onerous change in interest costs**

RD design assumptions

1. **What else is discontinuous around the threshold** (e.g., conservatism, capital structure, investments, auditor effort)?
   - Endogenously determined wrt ETR?
   - Suggestion – control for simultaneous discontinuities
2. **Distribution of covenant ratios around threshold – contradicts prior research?**
   - RD design invalid if accounting variables can be influenced
   - Extensive research in support (e.g., Sweeney 1994, Dichev and Skinner 2002)
   - Do you really need to fight this battle?

Where do we go from here?

- Ways to differentiate from the concurrent competing papers:
  - Focus on the mechanism through which banks can influence tax policy (directly or indirectly)
  - Horse race the ability of various external "monitors" to affect tax policy changes (e.g., lawyers vs. blockholders vs. banks vs. auditors)
  - Differentiate good and bad tax avoidance
- Focus on tightening the arguments (more important than additional robustness tests)
- Provide more descriptives and simple graphs – e.g., for violators and non-violators
- Post paper on SSRN!

Good luck!