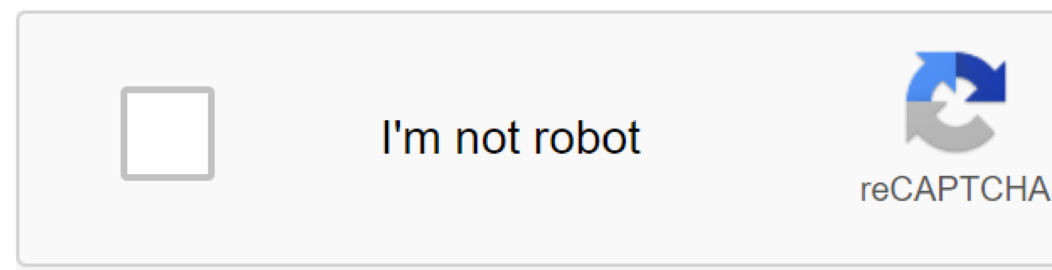
The leverage ratchet effect pdf



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This paper explores the dynamics of corporate leverage when making financing decisions for the benefit of shareholders. In the absence of prior liabilities or rules, shareholder-lender conflicts lead to a ratchet effect of leverage that encourages shareholders to resist cuts while in favor of increasing leverage, even if the total cost of maximization requires the opposite. Unlike inefficiencies based on asymmetrical information, leverage ratchet effect applies to all forms of leverage reduction, including income retention and entitlement offers. The effect of the lever ratchet is present even in the absence of friction, except for the inability to write full contracts. The effect is created by the agency the cost of debt, which reduces the cost of borrowing firms. Standard frictions increase the effect of the effect. In a dynamic context, since leverage becomes virtually irreversible, firms can limit leverage initially, but then ratchet it up in response to shocks. The resulting leverage dynamics can lead to results that cannot be explained by simple compromise considerations. Leverage can be adjusted in different ways. For example, a reduction in leverage can be achieved by issuing equity, either to buy back debt or to buy new assets, or by selling assets to buy back debt. We study shareholder preferences for different ways of adjusting leverage. The basic result gives conditions for shareholder indifference, but in general, shareholders have clear ratings on alternatives. For example, shareholders often prefer to reduce leverage by selling assets even at problematic prices. Anat R. Admati and Peter M. DeMarzo and Martin F. Hellwig and Paul Pfleiderer, 2013. The Ratchet Lever Effect, Max Planck Institute Discussion Paper on Collective Product Research 2013-13, Max Planck Institute for Collective Product Research, revised September 2017. Pen: RePEc:mpg:wpaper:2013/13 Other versions of this item: Admati, Anat R. and DeMarzo, Peter M. and Hellwig, Martin F. and Pfleiderer, Paul, 2017. Ratchet Lever Effect, Scientific Papers repec:stabus:3029, Stanford University, Graduate School of Business. Admati, Anat R. and DeMarzo, Peter M. and Hellwig, Martin F. and Pfleiderer, Paul, 2013. Ratchet Lever Effect, Scientific Works 3029, Stanford University, Graduate School of Business. Admati, Anat R. and DeMarzo, Peter M. and Hellwig, Martin F. and Pfleiderer, Paul, 2015. Ratchet Lever Effect, Scientific Works 3435, Stanford University, Graduate School of Business. Sudipto Bhattacharya and Kjell G. Nyborg, 2013. Bank Crisis Menu, Corporate Finance Research Review, Oxford University Press, vol. 2(1), pages 29-61. Bhattacharya, Sudipto and Nyborg, Kjell G, 2010. Bank Rescue Menu, CEPR 7906 documents, C.E.P.R. Discussion documents. Sudipto Bhattacharya and Kjell G. Nyborg, 2011. Bank Crisis Menu, FMG Discussion Documents dp668, dp668, A group of markets. Sudipto Bhattacharya and Kjell G. Nyborg, 2011. Banking Rescue Menu, FMG Discussion Documents dp676, Financial Markets Group. Sudipto BHATTACHARYA and Kjell G. Nyborg, 2010. Bank Rescue Menu, Swiss Financial Institute 10-24 Research Paper, Swiss Financial Institute. Myers, Stuart C. and Mailouf, Nicholas S., 1945-, 1984. Corporate Finance and Investment Solutions, when firms have information that investors do not have, Working Documents 1523-84., Massachusetts Institute of Technology (MIT), Sloan School of Management. DeAngelo, Harry and Stulc, Rene M., 2013. Why high leverage is optimal for banks, Working Paper Series 2013-08, Ohio State University, Charles A. Dice Center for

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These asymmetrical forces in adjusting the levers, which we call the lever ratchet effect, cause the results of the equilibrium lever to depend on history. If they are forced to reduce leverage, shareholders are biased in selling assets over potentially more effective alternatives such as net recapitalization. Please note that the publisher is not responsible for the content or functionality of any supporting information provided by the authors. Any requests (except for the missing content) must be sent to the author for the article. The full text of this article, posted on the iucr.org is unavailable due to technical difficulties. Work off campus? Learn about the inability of our remotely accessible companies to participate in future funding elections, which has profound implications for the dynamics of the capital structure. With debt repayments, shareholders everywhere resist a reduction in leverage, no matter how much such cuts can increase solid value. Instead, shareholders would choose to increase leverage even if the new debt is junior and will reduce the solid value. These asymmetrical forces in adjusting the levers, which we call the lever ratchet effect, cause the results of the equilibrium lever to depend on history. If they are forced to reduce leverage, shareholders are biased in selling assets over potentially more effective alternatives such as net recapitalization. Please note that the publisher is not responsible for the content or functionality of any supporting information provided by the authors. Any requests (except for the missing content) must be sent to the author for the article. The full text of this article, posted on the iucr.org is unavailable due to technical difficulties. Published 56 pages: August 2, 2013 Last revised: March 2018 Date Written: February 2018 The failure of firms to commit to future financing choices has profound implications for the dynamics of the capital structure. With debt repayments, shareholders everywhere resist a reduction in leverage, no matter how much such cuts can increase solid value. Shareholders would instead decide to increase leverage even if new debt is owed and will reduce the solid cost. These asymmetrical forces in adjusting the levers, which we call the lever ratchet effect, cause the results of the equilibrium lever to depend on history. If they are forced to reduce leverage, shareholders are biased in selling assets over potentially more effective alternatives such as net recapitalization. Keywords: capital structure, leverage, debt agency costs, dynamic capital structure, capital structure, capital structure compromise theory, capital regulation, Bank Capital, Debt Canopy, Arrears, Recapitalization, Share Borrowed Funds, Bankruptcy Costs JEL Classification: G21, G28, G32, G33, G35, G38, H81, K23 Proposed Citation Please use this ID to cite or link to this paragraph: Items in EconStor are protected by copyright, with all copyright protected, if not specified. Anat R. Admati, Peter M. DeMarzo, Martin F. Hellwig, Paul Pfleider Economics, Finance, Corporate Governance the leverage ratchet effect journal of finance

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