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The effect of banking relationships on the future of financially distressed firms

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ABSTRACT

In this study I empirically examine U.S. publicly traded firms to determine the impact of banking relationships on the future of financially distressed firms. Results demonstrate that obtaining a relationship-backed loan in the six months prior to distress identification significantly increases the probability of future firm emergence from distress. However, this effect decreases as the severity of firm distress increases. These results are robust to variations in banking relationship measures and to addressing endogeneity. This study provides evidence consistent with the value of lending relationships stemming from the ease of transmission of "soft" information within the lender's organization.

1. Introduction

A banking relationship develops when a lender repeatedly provides credit to a firm.[1] Repeated lending can reduce information asymmetries between the borrower and lender by providing lenders "soft" information on the firm's ability to repay debt. This "soft" information can include information on management's ability to overcome adverse situations, the firm's internal control of spending, and the veracity of the firm's financial statements. Information asymmetry between borrower and lender can be more evident when a firm is in financial distress, a time when there is more uncertainty regarding the firm's viability. Further, a firm facing distress needs funds to remain financially viable, so the firm is especially reliant upon the bank for funding while the bank maintains its interest in its current and future revenue stream. These circumstances of heightened information asymmetries paired with more prominent interdependence between firm and lender create a useful setting for the analysis of how reduced information asymmetries resulting from relationship lending affect financially distressed firms.

There are two views on how lending relationships affect financially distressed firms. First, it is reasonable to expect that relationship banks employ their informational advantage particularly when choosing to lend to distressed firms. This discretionary issuance of loans results in a benefit to both the financially distressed firm, by providing capital, as well as the lender, by providing the prospect of future rents upon emergence from distress. In contrast, Weinstein and Yafeh (1998) find that although prior lenders provide credit to a financially distressed firm, they inhibit the firm's ability to generate profits through higher interest payments and conservative investment policies, thereby weakening the firm's future prosperity and the bank's value of the lending relationship.

This study examines the effect of banking relationships on the success probability of financially distressed firms. Specifically, I perform probit regressions with controls for firm, loan, industry, and macroeconomic attributes to analyze the marginal effect that

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[1] Throughout this paper "bank" refers to any lending institution.

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banking relationships have on the probability of a financially distressed firm's future emergence from distress. While this is not the first study on how banking relationships affect firms (see Ongena and Smith (2000) for a review on banking relationships), this study contributes to the still growing body of knowledge on how lenders affect their borrowers' long-term performance.

The issue of how a banking relationship affects the performance of a financially distressed firm is an economically relevant question. When a firm maintains its viability, its creditors remain whole. However, once a firm defaults, that default not only affects the firm through increased cost of debt, detraction of management's attention away from daily duties, and general loss of employee morale, thereby creating more inefficiencies, but it also directly affects its lenders through possible losses.[2] Further, when the firm defaults, its stockholders suffer from being residual claimants below a possibly already impaired group of creditors. In sum, when a firm faces financial distress, that risk of default is born by the firm, its employees and stakeholders, the lender, and the lender's equity holders. Thus, understanding how a lender affects a financially distressed borrower's future performance is worthwhile.

This paper makes three main contributions. First, I find that obtaining distressed funding in the six months prior to distress identification from a relationship lender—defined as a lead lender that was a prior lead lender—has a positive impact on the emergence from distress of financially distressed large U.S. firms. Since emergence from distress increases the probability of the lender remaining whole on its loan to the distressed borrower, this positive effect on future firm performance is consistent with lending relationships not only having value to the distressed borrower, but also to its lender. Further, I find that as the degree of firm financial distress increases, the likelihood of future firm emergence from distress diminishes, even though the firm obtains relationship funding. That is, relationship lenders still provide credit to their severely distressed borrowers, even when the lenders can expect no advantageous future outcome from extending this credit. These findings are consistent with Weinstein and Yafeh's (1998) findings that relationship lenders provide credit to their distressed firms, while the findings are inconsistent with those of Elsas and Krahnen (1998), where German Hausbanks provide liquidity insurance to distressed firms, but only through moderate distress.

Second, I provide empirical evidence consistent with the ease of information transmission within a lending organization providing a mechanism through which lending relationships create value. Specifically, distressed firms seeking to replicate the benefits of relationship banking through a non-relationship lender may do so by borrowing from a non-relationship less-complex lender, measured by the number of entities within the lending organization, or by borrowing from a non-relationship comparatively-smaller lender (based on assets). This finding is consistent with Stein's (2002) theory that a decentralized organization, as opposed to a largely hierarchical organization, lends itself better to the transmission of “soft” information.

Finally, the main findings are robust to addressing the endogeneity of determining the lending relationships of loans to financially distressed firms. I use bivariate probit regressions to control for endogeneity, whereby I simultaneously predict future firm emergence from distress given an exogenous (actual) relationship and the nature of the lending relationship given an identifying instrument. In particular, I find that the firm's prior reliance upon relationship funding significantly positively predicts the distressed lending relationship, while rejecting the presence of endogeneity.

The remainder of this paper is organized as follows: Section 2 contains a literature review. Section 3 contains a description of the study's sample selection and provides variable definition and descriptive statistics. I describe the study's methodology in Section 4. In Section 5, I discuss the main results, while I discuss robustness checks in Section 6. I analyze mechanisms through which the relationship creates value in Section 7, and in Section 8, I address endogeneity. I conclude in Section 9.

2. Literature review

The modern literature on banking relationships has a foundation in James's (1987) study of bank loans, followed by Sharpe's (1990) and Rajan's (1992) work on the informational rents extracted by lenders, which establishes a set of testable theories for future empirical work. More recent empirical work analyzes German firms (Elsas, 2005; Elsas and Krahnen, 1998), Japanese firms (Weinstein and Yafeh, 1998), Belgian firms (Degryse and Ongena, 2005), Norwegian firms (Ongena and Smith, 2001), Czech firms (Ongena et al., 2011), Indian firms (Berger et al., 2008), Asian firms in financial crisis (Jiangli et al., 2008), small American firms (Berger and Udell, 1995; Cole, 1998; Petersen, 1999; Petersen and Rajan, 1994), and large American firms amidst formal bankruptcy proceedings (Dahiya et al., 2003a).[3] Houston and James (1996, 2001), Gonzales and James (2007), and Schenone (2004, 2010) also study banking relationships involving large publicly traded firms.

There are several hypotheses common to papers in this literature.[4] Most prominently, there is the notion that banking relationships alleviate information asymmetry through continued contact with their customers. This reduced information asymmetry can benefit the borrower through better loan terms (Berger and Udell, 1995; Bharath et al., 2011; Petersen and Rajan, 1994; Santos and Winton, 2008), more easily accessible capital (Cole, 1998; Cotugno et al., 2012; Jiangli et al., 2008; Petersen, 1999) and improved liquidity insurance (Elsas and Krahnen, 1998). My work adopts the information asymmetry hypothesis, but unlike earlier papers, I focus on the potential influence of banking relationships on the ability of publicly traded financially distressed firms to improve their financial position over an extended period of time.

My analysis evaluates the long-term effect of banking relationships on financially distressed firms. Such firms are unique both in their reliance upon external funding, which allows them to remain in operation, and in the increased information asymmetries created by distress. Although Dahiya et al. (2003a) investigate the impact of relationship debtor-in-possession financing, they

[2] When a firm defaults, Dahiya et al. (2003b) document that its lead lender's stock suffers a significantly negative abnormal return.

[3] These firms are beyond mere financial distress. They require legal protection in order to remain in operation.

[4] For a review of banking relationship literature, please see Ongena and Smith (2000).