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The effects of bank relationships on firm private debt restructuring: Evidence from an emerging market

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ABSTRACT

Our paper seeks to examine the direct benefit of bank relationships for a distressed borrower by assessing its influence on the success of firm private debt restructuring. We find that a distressed firm with a stronger bank relationship has a greater probability to successfully restructure its debt through private renegotiation. Accordingly, an analysis of credit rating recovery provides complementary evidence on the factors of successful debt restructuring. A duration analysis of the length of time needed for a debt restructuring to be completed is fully consistent with our documented results. We conclude that in a bank dominated financial system like Taiwan's where firms are heavily bank-dependent, the bank–firm relationship is of crucial importance to the success of financially distressed firms in private debt restructuring.

1. Introduction

Extant literature on financial intermediation (see, e.g., Diamond, 1984; Ramakrishnan and Thakor, 1984) emphasizes the role of banks in generating information, for instance, through screening (Diamond, 1991) and monitoring (Rajan and Winton, 1995). This access to information is especially relevant if the borrowing firm is in financial distress. A bank's evaluation of the borrowers based on their inside information affects the bank's decision to renegotiate the debt or force a firm into

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bankruptcy (Chemmanur and Fulghieri, 1994). While the borrowing firm encounters financial distress, previous lending relationships with the distressed firm create a significant negative effect on the lending bank (Dahiya et al., 2003). Consequently, when the borrowing firm is in financial distress, the lending banks have two options. First, prudent banking norms immediately require the firm to repay the debt regardless of the possibility of its recovery (i.e., an instant termination of bank relationships). Second, banks are insiders, with significant information advantages. They decide to extensively involve in the firm's private renegotiation and debt restructuring to recover losses (i.e., a continuation of bank relationships). Therefore, bank relationships may or may not benefit distressed corporate borrowers encountering financial distress. Relatively few studies in emerging economies investigate this issue. Thus, this study examines how bank relationships affect the probability of successful private debt restructuring for financially distressed borrowers.

Recent research has shown how bank relationships affect private debt restructuring of financially distressed firms. Brunner and Krahnen (2008) used the number of banks as a proxy for bank relationships and observed an extensive involvement of banks in their borrowers' debt restructuring and private workout activities. Brunner and Krahnen found that the probability of recovery from a distressed situation is negatively related to the number of banks. Couwenberg and Jong (2006) used bank debt as a proxy for the effect of bank relationships. Using this proxy, they studied the private restructuring processes in Dutch distressed firms. They found that bank debt has a significantly positive effect on the likelihood of restructuring success. While these studies show that bank relationships increase the value of distressed firms, bank relationship measures are susceptible to potential weakness, such as the degree of bank relationships measured by a single proxy. Indeed, if a firm requires fewer external funds, it would finance fewer loans with a smaller number of banks. In this situation, there is not a close or strong relationship between bank and firm. Moreover, the Taiwan financial structure is typically a bank-based financial system in which firms tend to be heavily dependent upon bank loans.[1] It seems inappropriate to employ a single proxy, the size of the bank debt ratio, for bank relationships because most firms have high bank debt ratios. Hence, in contrast to the previous literature which used only a single proxy for bank relationships, the conclusions of the present research may be robust to the different bank relationship measures.

The concept of a "bank relationship" is quite elusive in banking theory. There is no uniformly accepted methodology for measuring the presence and strength of bank relationships (Bharath et al., 2007). If the precise point of the start of a bank relationship is available, researchers often use the length of a relationship as a proxy for its strength (see, e.g. Petersen and Rajan, 1994; Berger and Udell, 1995; Elsas and Krahnen, 1998). In cases in which this information is not available, the existence of a prior bank relationship is used as a proxy (see, for example, Dahiya et al., 2003; Schenone, 2004; Bharath et al., 2007). Not having the precise records of bank relationships in the Taiwan banking industry, this present study adopts the existence of a prior bank relationship as a proxy for the presence of bank relationships. Moreover, this study looks at the size of bank relationships and the number of bank relationships by searching the borrower's previous borrowing records. In short, this study simultaneously discusses three measures of bank relationships to examine the effect of the success of private debt restructuring for financially distressed firms. These measures include the existence, size, and number of bank relationships.

The early empirical studies mainly have been concerned with the argument of formal bankruptcy procedures and have paid relatively less attention to out-of-court debt restructuring. Jensen (1989) is one of a few works that advocated that private contractual arrangements for resolving default represent a viable and less costly alternative to the legal remedies provided by Chapter 11. Gilson et al. (1990) further examined the determinants of 169 financially distressed firms' choice between formal bankruptcy and out-of-court restructuring. Gilson et al. found that about half (80 firms) successfully restructured their debt through out-of-court renegotiations and these firms have more intangible assets, a larger percentage of debt owed to banks, and fewer lenders.

[1] Shen and Wang (2005) reported that the external funding sources of Taiwanese firms account for 60% of the total funds. Among the entirely external funds, the largest shares are loans from financial institutions, particularly from commercial banks. Hence, bank relationships are of crucial importance for Taiwan's firms. Suggestively, the financial structure in Taiwan is much like a bank-based financial market.