The Value of Lending Relationships

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- Key findings:
  - Relationship capital is about 11.6% of the loan amount on average
  - The value of relationship lending is higher for banks' relationship with opaque borrowers and with borrowers that do not have access to alternative sources of financing
- Very important contribution to the literature!
  - Decades of research on relationship lending but no estimate of the quantitative importance of this relationship yet
  - Most papers have focussed on the benefits and costs of lending relationships for firms
  - Hard research question to answer since relationship capital is unobservable
  - Innovative use of enforcement of covenant breaches to infer the value of lending relationships for banks

Estimation Methodology

- Model a bank's decision to enforce a covenant breach
- Benefits: $\phi - \Delta\omega$
- Cost: ψ V
- Enforce iff $\phi - \Delta\omega \geq \psi V$
- Marginal enforcement: $V = \frac{\phi - \Delta\omega}{\psi}$
- Estimate $\Delta\omega$, and ψ using regression discontinuity regressions

Separability of V and ψ

- Let S denote the joint value from the match between bank b and firm f
- S is divided between b and firm f using a Nash bargaining rule
- Let x denote the optimal share of the surplus based on the bargaining rule
- Value to the bank from this match : $V_b^f = xS$
- Value to the firm from this match: $V_f^b = (1-x)S = \frac{(1-x)V_b^f}{x}$
- For a given value of S, $V_f^b = f(V_b^f)$
- Rewriting the equation that determines the bank's decision to enforce a breach
- Enforce iff $\phi - \Delta\omega_{bf} \geq \psi(V_b^f)V_b^f$
- In this case, can we still estimate V_b^f using $V = \frac{\phi - \Delta\omega}{\psi}$

Role of new relationships

- While thinking about the tradeoff associated with banks' choice to enforce the breach, should we also think about reputation costs and potential new relationships?
- Gao et al. (2021) shows that banks strategically choose to not flag suspicious activities because doing so will give a signal to potential money launderers about the banks' reporting policy
- Do banks think about the potential of forming new relationships when they choose their enforcement strategy?
- Cost of enforcement will be even higher

Measurement of key variables

1. One-time switch vs terminating the relationship
   - The risk of enforcing the breach is that the customer will terminate the lending relationship with the bank
   - ψ estimated using the following model:

$$Switch_{ikt} = \alpha + \beta_{Switch} * \widehat{Enforce}_{ikt} + F(Slack_{ikt}) + G(Slack_{ikt}) + \epsilon_{ikt}$$

$$Enforce_{ikt} = \eta + \lambda * Breach_{ikt} + F(Slack_{ikt}) + G(Slack_{ikt}) + \delta_{ikt}$$

   - "*Switch*" equals 1 if the borrower's next loan is with a different lender other than the lender which enforced the breach
   - Better to construct a measure of relationship termination to better map it to the conceptual framework
2. Expected cost of default: better to express this as a percentage of bank capital

Other Comments

- Repeated breaches by the same firm
- Firms for which breach is not enforced more valuable?

Conclusion

- Very interesting and innovative paper!
- Lots of avenues for future research
- Some more clarity needed on the relationship between different variables
- Look forward to reading the next version of the paper