



The role of bank relationships when firms are financially distressed



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ARTICLE INFO

Article history:

Received 17 December 2013

Accepted 8 January 2016

Available online 23 January 2016

JEL classification:

G21

G33

L14

Keywords:

Financially distressed firms

Relationship banking

Bank type

Firm closure

ABSTRACT

Banks are better suited than other financing partners to process information in order to make efficient liquidations. But their ability depends on bank characteristics and incentives. In addition, the strength of the main bank relationship influences the bank's ability to make efficient liquidations. I study the effect of bank characteristics and bank relationships in situations where firms are financially distressed. Do the chances of a financially distressed firm to improve or to close depend on the bank? Does the survival of a financially distressed firm depend on its main bank relationship? Using German data from 2000–2013, I analyze the effect of a bank's organizational complexity, non-performing customers, and the strength of main bank relationships at the bank and firm level. I find that high shares of non-performing clients provide negative incentives. Banks can make more efficient liquidations if they are regionally active and have close relationships with the firm.

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1. Introduction

Firm–bank relationships are special in reducing information asymmetries between borrowers and lenders. Empirical and theoretical studies have documented the valuable features and characteristics of close firm–bank relationships, such as lower loan rates, less stringent collateral requirements, or insurance against adverse aggregate credit shocks (Berlin and Mester, 1999).

In addition, banks can insure against liquidity shocks. Banks gain proprietary information when screening and monitoring borrowers (Fama, 1985). Compared to the holders of publicly traded debt, banks have more incentives to use their own resources in order to evaluate the viability of firms (Diamond, 1984; Chemmanur and Fulghieri, 1994). As a consequence, banks make more efficient decisions on the liquidation of a firm versus renegotiation (Chemmanur and Fulghieri, 1994). Banks have access to private information, observing the behavior of a firm's management, and can influence the firm's decisions (Fama, 1985). This allows banks to “lean against the wind” and remain with their customers when they are most in need (Petersen and Rajan, 1995).

A bank's ability to offer valuable features to firms is influenced by, e.g., its liability structure (see Berlin and Mester, 1999 for loan rate smoothing) or banking market competition (Boot and Thakor,

2000). Further, banks differ in the composition of their business client portfolio and institutional background, which influences their ability and strategy to deal with financially distressed firms.

In this study, I analyze the influence of the main bank characteristics on the survival rate of financially distressed firms. In particular, I focus on the following questions: Does the probability of a firm's survival increase with its main bank's ability to process soft information? How do difficulties within the bank's portfolio affect the survival of financially distressed firms? Do firms with multiple bank relationships have coordination difficulties and exit the market with a higher probability? How do discontinuities in the main bank relationships affect the status of financially distressed firms?

There is a growing literature on banking and the financing of small and medium sized enterprises. While most studies are concerned with the access to finance, lending technologies, and terms and conditions, only a few studies have focused on financial distress and bank relationships. Dahiya et al. (2003) analyzed the effect of a firm's failure on the value of the bank. Studies of the recovery rates of distressed firms have tried to measure the effect of firm or entrepreneurial characteristics on losses, given default (e.g. Grunert and Weber, 2009). The studies most related to this one focus on banks' role in reducing the costs of financial distress in Japan during the 1990s (e.g. Peek and Rosengren, 2005; Fukuda et al., 2009; Shimizu, 2012). Compared to those studies, my dataset allows analyzing the effects for all firm sizes under “normal” economic conditions.

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For the empirical analysis, I use data on German firm–bank relationships to address these questions. The data set represents a 10% random sample of German firms active in the years 2000–2013. The panel covers semiannual firm observations. The data was collected by Creditreform, the largest German credit bureau. The dataset contains firm characteristics, such as the firm’s industry, location, date of incorporation, main and further bank relationships. It was supplemented with information from the ZEW Bank Panel concerning bank type, bank portfolio, and local banking market characteristics. Based on the firm’s payment status, I observe episodes of financial distress, as well as the status of the firm after distress. In addition to firm closure, I distinguish between firms that survive but remain in financial distress and firms with improved ratings.

The dataset allows analyzes on two levels. At the bank level, I analyze the effect of a bank’s organizational complexity and non-performing customers on its share of financially distressed firms that either improve or close. At the firm level, I employ further variables describing the main bank relationship. Here my interest is in the financially distressed firm’s probabilities of recovering and of closing.

My main findings are that small banks have higher shares of improved firms and lower shares of closed firms. Also, at the firm level, bank size has a positive effect on survival and improved ratings. Small banks tend to be more capable of processing soft information. This type of information can be important for efficient liquidations of financially distressed firms. I find “perverse incentives” similar to Peek and Rosengren (2005), in that banks with difficulties in their loan portfolio are more likely to keep distressed firms alive. I find the effect for both the bank and firm level. However, I also show that firms having a relationship with such a bank are more likely to become financially distressed in the first place. Strong main bank relationships have a positive effect on a firm’s survival probability. Banks have little private information on firms that have only recently become their customers. Such banks find it harder to make efficient liquidations. Banks face coordination difficulties, free-rider problems, and information asymmetries if the firm has multiple bank relationships. However, if firms are able to renegotiate with several banks, they have a higher probability of improving their ratings. Banks have insufficient private information regarding new clients to make efficient liquidations. Firms that have recently switched their main bank show a higher probability of closure. I find mixed results regarding a bank’s institutional background and governance structure. The bank level results show that *Sparkassen* and cooperative banks have higher shares of distressed firms that improved their rating and lower shares of distressed firms that closed. In contrast, the firm level results show that the probability of closure is higher for financial distressed firms that use a *Sparkasse* or cooperative bank as their main relationship.

The present paper is structured as follows. In Section 2, I introduce the hypotheses regarding the effects of firm–bank relationships on the survival of financially distressed firms. In Section 3, I describe the German banking market and discuss the potential effects of the institutional differences of German banks. In Section 4, I present the data set and the empirical models. In Section 5, I present the results of the xtobit model of the bank level and the multinomial probit model of the firm level analysis. In Section 5.1, I provide further robustness checks, such as a Heckman Probit model in order to control for potential selection biases, and discuss the results. I conclude in Section 6.

2. Hypotheses

Diamond (1984) argues that it is efficient for debtors to delegate monitoring to banks. Banks add value, producing information

about creditors and deciding on the most efficient asset allocation. While banks monitor projects, they need to liquidate inefficient projects. In addition to publicly available information, banks use private information to justify the decision to liquidate and reallocate funds. Chemmanur and Fulghieri (1994) argues that lenders choose a financing partner according to their own risk as well as the financing partner’s ability to identify bad projects. An important kind of added value for firms in financial distress is that banks with expertise make more efficient liquidations (Chemmanur and Fulghieri, 1994). Those banks are better able to evaluate firm liquidation value vs. going-concern value. This allows identifying viable firms, rather than liquidating every distressed firm. Banks need to invest in expertise in order to act as a relationship lender and add value for the borrowers (Boot and Thakor, 2000). They also rely on sufficient private information to identify good and bad projects once they receive a bad signal. In certain circumstances, banks have incentives not to liquidate insolvent firms but keep “zombie firms” alive (Caballero et al., 2008), e.g., if the banks themselves are in difficulties (Peek and Rosengren, 2005).

I elaborate four hypotheses on the effect of a bank’s characteristics on its ability and incentives to make efficient liquidations. I focus on the bank’s ability to process soft information, and the share of non-performing customers that are directly related with the bank’s organization and portfolio. I elaborate hypotheses on the strength and duration of the relationship between a firm and a bank.

2.1. Soft information processing

Banks can use different types of information when it comes to financing or to renegotiating contracts (Berger et al., 2001; Main, 2006; Jimenez et al., 2009). Stein (2002) distinguishes between hard and soft information. Hard information can be verified, such as financial data or ratings. In contrast, degrees of trust or character assessment can be described as soft information. It is produced by an agent, e.g., a bank official, and cannot be directly verified by others. This type of information becomes especially valuable once a firm is financially distressed and needs to restructure its debt. Stein (2002) argues that banks are not all alike in their ability to process soft information. More complex or hierarchically organized banks are less able to process soft information.

In the case of financially distressed firms, soft information can have two effects. Either bad hard information is supported and the firm gets liquidated, as it would without considering soft information, or soft information attenuates the bank’s decision. The liquidation rate of financially distressed firms should therefore decrease with the main bank’s ability to process soft information.

Hypothesis 1. A financially distressed firm’s probability of survival increases with its main bank’s ability to process soft information.

2.2. Non-performing customers

The capacity of a bank to absorb financial shocks from a firm in its portfolio by providing additional financing is restricted once the bank itself suffers substantial losses. One should therefore expect that the probability of market exits of financially distressed firms increases with the bank’s rate of loan defaults. In contrast, Peek and Rosengren (2005) find that distressed Japanese banks keep financing weak firms. They argue that troubled banks have an incentive to avoid the realization of additional losses on their own balance sheet by allocating funds to borrowers in financial distress. By avoiding or delaying the firm’s bankruptcy, the bank is not required to report such non-performing loans. Peek and Rosengren (2005) observed this phenomenon in Japan during a

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