Discussion of:

“The value of lending relationships”

by Bird, Hertzel, Karolyi, and Ruchti

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Introduction

- This paper attempts to quantify the value of a bank's relationship with its borrowers
  - Based on the tradeoff between relationship termination and increased fees / lower risk when encountering a covenant violation in the underlying loan
  - Relationship value varies (sensibly) in the cross section of borrowers:
    - Greater relationship value when borrowers are opaque (and the incumbent lender therefore has an information advantage over other potential lenders)
    - Greater relationship value when borrowers have fewer options for alternative sources of financing
    - Greater relationship value when there are greater opportunities to cross-sell other services to the borrower
      - Many of these (except perhaps the last in that list) give the relationship value to the lender because they can expropriate wealth from the borrower via higher spreads, fees, etc…
    - Market values appear consistent with the authors' estimated value of lending relationships

- Overall, this is a great paper that addresses a really important empirical question (value of relationships) with a clever identification strategy
  - The use of "fuzzy" regression discontinuities seems appropriate
    - Old dog, new tricks
  - Most of what I will talk about today is not what *is* in the paper, but rather what *is not*

Lending relationships…

- It was difficult to tell from the paper, but the vast majority of loans in the data must be syndicated loans (as that is the dominant form of lending in the DealScan database)
    - The phrase "syndicated lending" is also the first phrase in the paper's keywords!
    - The paper uses phrases like "***the*** lender can enforce the breach"
        - But in a syndicated loan, who is ***the*** lender?
        - How can the authors assign decision rights (for example, to enforce a covenant violation) to any one of the multiple lenders in a typical syndicated loan? To the lead lender?
        - And then tie that enforcement to the value of a specific relationship to that lender and also to other syndicate members?

- In my experience, borrowers will do what they can to reduce the value to the lender of these relationships, especially when the value comes from their expropriation
    - I am a small shareholder in a private firm where both Goldman Sachs and Morgan Stanley are large shareholders (via their VC arms) and have board seats
    - Executives from that firm attend "investor conferences" at least twice a month
    - This paper's approach feels a little bit like a partial equilibrium, as (I think) the authors do not discuss competitive reactions by borrowers

Other relationships…

- Jensen and Meckling (1976)
  - The firm is a "… nexus for a set of contracting relationships"
  - Banks maintain ***a lot*** of relationships
    - Including with providers of capital (depositors)!

- One would be remiss in May 2023 to discuss a banking paper and not mention the regional bank mini-crisis that we are apparently still in the middle of
  - Silicon Valley Bank (SVB) was one of the first casualties
  - SVB had a somewhat unique business model
    - SVB would make loans to startup founders (for wineries, houses, yachts…), *as long as they agreed to deposit with SVB the cash their startups got from VCs*
    - Once those depositors started to suspect that SVB was undercapitalized given losses in its asset portfolio, a classic bank run (in the age of Twitter) ensued
    - SVB may be in the sample for this paper, and even if it is not SVB likely thought that it had very valuable (and somewhat unique) relationships with its borrowers heading into 2023
    - But those borrowers were often also depositors! Once the trust in the relationship with those depositors disappeared, the bank was insolvent in a matter of hours and the value of relationships with *both* borrowers and depositors went to zero

Conclusions

- Overall, a great paper that is well worth reading!
    - I think the overall idea of trying to quantify the value of a firm's relationships (banks in this specific case, but this could apply in other contexts) is excellent and I suspect that this paper will find a home in a great journal
    - My major concern is only really that the setup here feels like a partial equilibrium
    - The authors do not appear to account for both:
        - Competitive reactions by current borrowers to the risk of being expropriated by their lenders; and…
        - The value of the many other relationships in the "nexus of contracts" that define the modern corporation

    - I'm not convinced that a full equilibrium approach is necessary in this paper
        - That's a lot to ask!
        - But in my opinion thinking about ***what is not*** in this paper is a useful way to give context to ***what is*** in this paper