Shadow seniority? Lending relationships and borrowers' selective default

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This paper finds a new benefit of lending relationships for banks. We show that borrowers in financial distress prioritize debt repayment to their most important banks to preserve the most valuable bank relationships. Thus, the most important banks of a firm enjoy a shadow seniority. Results seem driven by firms' interest in preserving the benefits of most important lending relationship, as we also find that the payment priority becomes stronger in microenterprises, and it is positively related to the duration and breadth of the relationship. The economic effects are relevant because one standard deviation increase in the firm's share of outstanding debt with a particular bank reduces the probability of default with the bank from a mean value of 2.5% to 1.8% (a relative decrease of about one-quarter).

Our empirical study uses a granular, quarterly, supervisory loan-level database of Spanish firms that experienced financial distress over the 2016Q3-2019Q4 period. Our analysis controls for potential bank forbearance and for any other bank behavior (recovery enforcement, internal accounting practices, credit risk models, etc) affecting the recognition of delays in loan repayments by including bank-quarter fixed effects. The aim is to identify the borrowers' incentives to repay debt. We also control for loan, unobservable borrower quality, or other bank-firm characteristics, different to the importance of the bank for the firm that could affect the incentives of the borrower to repay debt by including firm-quarter and bank-firm fixed effects. The results are robust to the use of alternative subsamples to analyze the effect of different types of loans and to the inclusion of bank-quarter-province fixed effects to control for potential differences in, for instance, bank competition or judicial efficiency across Spanish provinces.

We confirm the results when we analyze the main bank acquisition in our dataset. This acquisition allows us to exploit the exogenous increase in the importance of the acquirer as a lender to firms borrowing from both the acquirer and the target before the acquisition compared to firms borrowing only from the acquirer. After applying a difference-in-differences (DID) analysis around the acquisition, we only find a reduction in loan delinquency in the first type of borrowers. This finding is consistent with an increase in the incentives of these borrowers to repay bank debt following an increase in the

importance of the acquirer as a lender after the acquisition and provides additional evidence on causality running from the borrower's repayment incentives to the recognition of loan defaults.

Our findings also indicate that lower bank solvency increases borrowers' incentives to prioritize debt repayment the most important banks. This behavior is consistent with borrowers anticipating that less capitalized banks may cut credit more likely in case of a payment delay or that they can provide greater forbearance benefits during normal times. Furthermore, we show that banks internalize borrowers' debt repayment and recognize lower discretionary loan impairments in firms where the bank is one of the most important lenders.

Overall, our results suggest that loans granted by the most important bank enjoy a shadow seniority relative to similar loans from other banks. They suggest a new channel through which relationship lending can help reduce loan default rates and bank credit risk. Relationship lending not only improves screening and monitoring by banks, as already suggested by the literature, but also increases the incentives of borrowers to prioritize debt repayment in case of financial distress to preserve the most valuable lending relationships.

In terms of regulatory implications, our results suggest the advisability of incorporating the importance of the bank for the borrower in bank risk measurement. Current regulation focuses on loan, firm, and macroeconomic variables to measure credit risk, but greater attention to borrower incentives to prioritize debt repayment can provide additional information. In particular, the greater importance of the bank within a firm's set of lending relationships reduces the borrower's incentives to default and diminishes credit risk, which is essential to safeguard financial stability and sustain the credit supply.