Network-Motivated Lending Decisions*

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Abstract

We theoretically and empirically demonstrate that monopolistic or collusive banks will keep lending to a loss-making firm at an interest rate lower than the prime rate if the firm is located in an influential position in an inter-firm supply network. An influential firm generates a positive externality, and its exit damages the sales in the supply network. To internalize this externality, the banks may forbear on debt collection and/or bail out such influential firms when the cost to support the loss-making influential company can be recouped by imposing high interest on less influential companies. The analytical model shows that such forbearance can improve welfare. Our empirical study, performed using a unique dataset containing information about inter-firm transactions, provides evidence for such network-motivated lending decisions. In particular, this effect is more clearly observed at less credit-worthy firms whose main bank is a regional bank. Notably, we observe that such banks are often dominant lenders in the local loan market, and most of their clientele do not have direct access to the stock and bond market.

Keyword: supply network, influence coefficient, centrality, forbearance, bailout

JEL Classification: C55, D57, G21, G32, L13, L14

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