

A Reexamination of the Role of “Relationships” in the Loan Granting Process

Sugato Chakravarty and Tansel Yilmazer
Purdue University

Federal Reserve System Research Conference
April 7-8, 2005

What do we learn from previous literature?

Relationships are a significant determinant of credit rationing in loans associated with small businesses and individual families.

Implication: Loan rates can be lowered with good relationships with potential lenders.

However, these studies do not account for the fact that loan approval and rate setting are correlated decisions.

The overall loan granting process can be described by

[The Application Decision] a borrower's decision whether to apply to the lender (usually a bank) for a loan (or not),

[The Credit Approval Decision] whether a bank approves the application for a loan (or not),

[The Loan Rate Setting Decision] the loan rate the bank chooses for the borrower.

Goal of this study:

To investigate whether relationships have a distinct role in different stages of the loan process

Conclusion:

- Relationships have an important role in the application and credit approval stages of the loan process.
- Relationships are not important in determining the loan rate for consumer loans and small business loans.
- Our findings resonate with Bank Loan Officers.