Research Proposal

Title: *Financial Repression and Relationship Banking*

Author: *Seyyed Javad Kashizadeh*

Supervisor: *Dr. Pejman Abedifar*

Institution: *Tehran Institute for Advanced Studies*

Research Objective

Extant literature points out the role of retail banking relationship on allocating the underpriced assets between banks' clients (Puri and Rocholl (2008)). Using Iran's unique setting, this paper attempts to understand the role of the banking relationship on the allocation of loans during severe negative real interest rate.

Motivation

Puri and Rocholl (2008) show that German banks pass information about underpriced IPOs to their own clientele at the time of underwriting. As a result, each underwriter banks' clienteles have both more demand and allocation on highly underpriced IPOs. But what if loans are underpriced assets? To answer this question, we use Iran's unique financial repression setting. While from 2013 to 2017, the average real interest rate was about 7%, the chronic inflation from 2017 to 2021 led to lower than -15% real rates. The problem arises from the extensive interest rate control of the government. An important question is that who can get these cheap resources? We expect that banks prefer to direct resources to their own clients at the time of excess demand for underpriced loans.

During the period of severe negative real interest rate, not only are banks inclined to allocate the underpriced loans to the clients with a high level of relationship, but also clients' behavior on their account balances may be influenced by their relationship. The intuitive reason comes from the trade-off relationship clients face during negative real rate periods. On the one hand, relationship clients are more likely to receive underpriced loans with their deposit balance. On the other hand, negative real rate erodes their deposits. We expect that the level of the relationship can mitigate the severity of the deposit running of the clients.

Additionally, the central authority of banks will restrict branches' lending when the total amount of the loans exceed their resources. In other words, branches have to reduce their lending when their predetermined balance resources are decreasing. We then try to shed light on whether branches allocations differs during lending restrictions.

Data

Cooperating with one of the biggest Iranian banks, we use proprietary information of about one million clients related to almost one hundred branches. The set of variables include borrowers' characteristics like age and sex, loan terms and origination date, detail information on monthly balance of clients' different accounts and different monthly measures of the relationship with clients like monthly profit of bank from multiple interactions with client and loan originations history. The time-span of dataset is from 2015 to 2021, including two years with positive and three years of severe negative real interest rate.

Moreover, we have comprehensive information on daily records about the total outflow and inflow of braches' resources, which helps us investigate the branches' lending behavior during lending restrictions.

Methodology

Using panel regression we will try to investigate the role of the prior relationship on the loan granting and account balance behavior of client during period of negative real interest rate. We will use random effect model to capture the effect of both time variant and invariant variables.

Contribution

While Puri and Rocholl (2008) investigate the role of the relationship on the allocation of underpriced IPOs, our novel setting allows us to focus on how retail banking relationships affect lending when the negative real interest rate results in underpriced loans. Moreover, we point out whether the relationship can affect the deposit holding of the clients when negative real rate penalizes depositors.

Policy implication

From the POST-WWII era, with reducing the cost of the debt, financial repression has been one the most effective tools for lowering government debt-to-GDP and incentivize investment. As the second-largest economy globally, China is one the most striking examples of how financial repression especially negative real interest rates can affect household savings, residential property market and misallocation of the resources (Lardy). There is a serious concern about who benefits the most from this stealth redistribution of resources in the society. Our investigation tries to answer part of this important policy concern. We showed that relationship clients are one group of lucky winners of these cheap resources while the burden is on the shoulder of all savers in society.

References

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[2] Lardy, Nicholas R. (2012), *"Sustaining China's Economic Growth After the Global Financial Crisis"*, Washington, DC: Peterson Institute for International Economics.