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Relationship banking during times of distress

A study of what factors affect the actions taken by Swedish banks when a borrowing firm is undergoing financial distress

Tobias Andersson [£] Sofia Helgesson [$]

Abstract

This paper investigates what factors affect Swedish banks' behaviour in situations where medium sized commercial customers experience financial distress. The empirical findings are based on qualitative data acquired through 27 interviews with representatives from the four largest Swedish banks, financial advisors and experts, as well as equity investors. Our results indicate that Swedish banks rarely terminate the relationship with a borrowing company in financial distress. Governing factors behind such a course of action are relationship reasons, reputational effects as well as the Swedish bankruptcy legislation and accounting standards. On a few occasions, the banks might terminate existing relationships due to the unviable nature of a customers' business or as a result of equity holders acting dishonestly. However, our empirical research suggests that Swedish banks' primarily seek to retain existing relationships and instead salvage their outstanding loans and credits through a mix of financial and operational measures. This thesis adds to existing knowledge, as it highlights how relationship banking affects the resolution of financial distress. Also, we offer an insight into why certain actions are taken and the role of creditors in the corporate governance of financially distressed companies.

Key words: Financial distress, relationship banking, turnaround, Swedish banking

Tutor: Katerina Hellström
Date: 2013-12-09

[£] 21603@student.hhs.se
[$] 21650@student.hhs.se

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Tobias Andersson Sofia Helgesson

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1. Introduction

In a recent report, the Scottish bank RBS was criticised for forcing several financially distressed companies into bankruptcy (Large, 2013). Concerns were raised that "'viable' companies were deliberately 'sunk' by [RBS] to extract 'maximum revenue'" (Bounds, 2013). Swedish banks have been exposed to the same criticism: "The bank forced Nimbus into bankruptcy" (Hopen, 2012) and "In the end, SEB decided to terminate the credits" (Lindblad, 2013) have been recent reads in Swedish newspapers. In similar cases banks are blamed for "only considering their own interests and taking the easy way out" (Haggren, 2013) - instead of trying to save companies in financial distress, the banks are criticised for withdrawing the credits and forcing the borrowers into bankruptcy.

From these articles, we can see that banks possess much power and their decisions have the possibility to affect many stakeholders. However, bankruptcies are not necessarily the easy way out, not even for the bank. As explained by von Seth (2013) on the recent default of the Swedish education company JB: "particularly the banks that had lent money to the group took the biggest hit". When a company is in financial distress, implying that it cannot or has difficulties meeting its financial obligations to its creditors, the bank has two choices. It can choose to either terminate or retain the relationship. The consequences of the bank's decision are potentially large and impacts many stakeholders besides the bank.

Several studies have sought to investigate what factors that affect a bank's decision to terminate or retain an existing relationship with a commercial customer in financial distress. The structure of the company's debt has been found to have a large impact: the more dispersed the lender base and the more debt is held by public bondholders, the higher the risk that the credits will be withdrawn (Brunner and Krahnen, 2008; Bolton and Scharfstein, 1996 and Bulow and Showen, 1978). Collateral has also been found to have an impact on the bank's decision to recall an outstanding loan. While some researchers find that banks that are protected by collateral are more likely to withdraw the credits (see for example Gilson, 1990), others find that the existence of secured debt increases the chances of the creditor supporting the company in financial distress (Elsas and Krahnen, 2000). Additional factors that have been found to have an impact on how the bank treats a distressed borrower are for example the bankruptcy legislation in the specific country (Jostarndt and Sautner, 2010), the existing relationship between the borrower and the bank (Li, Lu and Srinivasan, 2013) and the bank's desire to retain a certain reputation (Moussu, Troege, Europe and Refi, 2013).

A number of studies have also investigated the actions following a bank's decision to terminate or retain the relationship with a distressed company. Peek and Rosengren (2005) find that Japanese banks try to save borrowers by offering extended credits. Further, Elsas and Krahnen (1998) see that German banks help their borrowers by lowering the interest rates when the borrowers experience financial distress. Contrary results have been found by Li, et al. (2013) in a study of American banks. They find that the banks rarely offer additional credit and instead tend to increase the interest rate charged to distressed companies. It is also debated to what extent banks write down their claims: Jostarndt and Sautner (2010) find many cases of debt forgiveness in Germany, while other authors find that it practically never occurs (for example Couwenberg and De Jong, 2006 and Franks and Sussman, 2005). The diverging findings of previous articles can, at least to some extent, be contributed to different countries being studied. In addition, the researchers tend to focus on companies with dissimilar debt structures. In fact, most of the previous research is based on larger, publicly listed American companies with dispersed borrowing.

Moreover, previous researchers have almost exclusively used quantitative methods in their research. Their choice of method limits the ability to gain a deeper understanding about why the banks act in certain ways. We therefore aim to increase the knowledge of the banks' rationale by conducting a qualitative study. Also, our purpose is to focus on Swedish banks; a setting that has not gotten much attention from previous researchers.

Several reasons make the Swedish setting interesting to study. To begin with, it is a bank-dominated economy: the four largest banks together account for 73% of the total bank lending (Nilsson, 2013), there are few private debt investors and the market for corporate bonds is underdeveloped (Gunnarsdottir and Lindh, 2011). In addition, the banks engage in "relationship banking"; a form of lending that is characterised by strong customer relationships (Gunnarsdottir and Lindh). Such lending is also found to have an impact on how banks treat borrowers undergoing financial distress (Boot, 2000). In addition, Swedish banks have fewer bank relationships than what is common in other parts of Europe: the majority of Swedish medium sized companies with bank debt only have one bank (Ongena and Smith, 2000).

The Swedish setting has previously been studied by Strömberg and Thorburn (1996) and Thorburn (2000), who focus on large bankrupt Swedish companies. However, this limits their findings to only apply for companies that later file for bankruptcy. In our study, we will focus on privately owned, medium sized companies (20-50 MEUR in sales)[1] since relationships with the creditor is expected to be most important for medium sized firms. This is attributable to them being increasingly opaque compared to large, listed corporations (Boral, Carty and Falkenstein 2000). Also, we look at companies with only one bank; thus excluding any adverse effects arising from relationships within the group of creditors. In this thesis we aim to answer the following questions:

1. What factors affect the banks' decision to terminate or retain the relationship with a company that undergoes financial distress?

2. What actions are taken if:
   a) the bank decides to terminate the relationship, and why are they taken?
   b) the bank decides to retain the relationship, and why are they taken?

In order to answer these questions, we have conducted in-depth interviews with individuals representing all four major Swedish banks, one minor bank, financial advisors, legal advisors, bankruptcy trustees and company owners. We have also interviewed Per Strömberg, professor at the Stockholm School of Economics. A total of 17 interviews have been conducted. In addition, we have attended a panel discussion where three industry professionals discussed Swedish restructurings and bankruptcies. Altogether, we have met with 27 different people from 13 different organisations in order to attain a broad understanding of our research questions.

We have found that the banks are reluctant to terminate the relationship with a distressed customer due to the existing relationship - since they prioritise long-term relationships built on trust - and reputational issues - affecting the banks' ability to attract future customers. Additional

[1] OECD's definition of medium sized companies

factors that have been found to have an impact are bankruptcy legislation and accounting standards. Also, the banks are aware that, in case the relationship is terminated, the borrower is likely to be forced to file for bankruptcy. The banks are likely to terminate the relationships with distressed borrowers if either of two factors prevails: if there is no market for the company and its products or if the bank has no trust in the character of the owners. If indeed the bank chooses to terminate the relationship, it is most likely to do so by withdrawing the credits. This action is preferred since selling debt is not considered an option, given the accounting standards in Sweden, and filing for bankruptcy on behalf of the company seldom is done due to the bankruptcy legislation.

Since termination of the relationship is not commonly done, we have found that Swedish banks instead try to get their distressed customers back on track. To do this, the banks typically use a mix of financial and operational measures, for example lowering the interest rates, advise the companies on how to restructure the operations and influence who is allowed to hold management positions. Because liquidity shortages often are acute, capital injections from either equity owners or the bank are in many cases also necessary. In addition, banks often evaluate replacing cash-constrained owners with new equity investors that are more willing to cover capital shortages. As a last resort, the bank might consider taking over the company entirely through converting the debt to equity.

We also see that the actions banks take will depend on the value of the distressed company and which claimant is impaired. As long as only equity is impaired, banks are likely to focus on financial and operational measures to ameliorate the short-term situation of the borrower. The further the value deteriorates, and the closer the bank debt is to impairment, the more forcefully they are likely to engage in the company, in order to mitigate the distress.

While banks invest both time and resources into their rescue operations, we see that they do not do this for the purpose of being nice. Rather, the banks try to get the companies back on track out of pure business: by keeping a distressed company away from bankruptcy the bank avoids costly credit losses, while also securing future revenues. The Swedish banks therefore seem to be the opposite of RBS: instead of rapidly liquidating the distressed firms in order to maximise their value, they engage heavily in the distressed borrowers to reduce potential credit losses.

2. Previous research

A number of researchers have, at least partially, addressed issues that relate to our subject. We aim to describe their findings and, where relevant, in what way their research is similar or dissimilar to our study. Firstly, we present a holistic framework for initial credit decisions and factors that have been found to be of importance in such a setting. We have chosen to include this research since there is limited amount of research only focusing on factors found to have an impact when the borrowing firm is facing financial distress. We also introduce three additional factors that have been found to be of importance when companies are in financial distress: relationship, regulatory setting and reputation. Secondly, we account for actions that previous researchers have found that banks take when borrowing firms are in financial distress. These are divided into three parts: financial measures, operational measures as well as converting debt to equity & capital injections.

2.1 Factors affecting banks' initial credit decisions and treatment of companies in financial distress

2.1.1 The Five C's of credit - a framework for initial credit decisions

The question of what factors affect the bank's decision to grant a company credit is widely discussed in previous research (see for example Berry and Robertson, 2006; Kwok, 2002). However, this is limited to granting initial credit to healthy companies and not when a current customer is in financial distress.

Lacking a framework that is developed specifically for a distressed setting, we will use the Five C's of credit (Beaulieu, 1994) to describe factors that have been found to impact banks' treatment of borrowers undergoing financial distress. Since this research is limited, we will also include how the factors impact initial credit decisions. The Five C's of Credit incorporates factors that all influence in the initial credit decision (Beaulieu). The C's consist of: Character, Capacity, Capital, Collateral and Conditions.

Several studies have tried to rank the relative importance of these factors but the authors' conclusions are not univocal. Baiden (2011) argues that the Five C's must be used together as they are interrelated and the relative importance of individual factors differs from case to case. These factors are described further below to understand how they might affect the banks decisions.

Character

Character reflects the characteristics of management and owners and their willingness to repay the debt. Integrity, honesty, reputation and stability are words, used by Beaulieu (1994) to describe Character. Baiden (2011, p.10), who discusses the relative importance of the Five C's, withholds that this is the single most important factor during initial credit decisions since, "loans are always repaid by people, not numbers". Beaulieu (1996), who investigates what information American loan officers use in initial credit decisions, also finds support for Character being important. The author concludes that bad quality of management and owners have the potential to significantly reduce the chances of credit being granted to an otherwise healthy company. The importance of good character is also noted by Danos, Holt and Imhoff (1989). They investigate what kind of information is used by loan officers when granting credit in a non-distressed American setting, and show that lending decisions to existing customers are based heavily on interpersonal relationships.

Conditions

Conditions reflect the prevailing economic conditions, such as the business cycle or the outlooks of the market in which a company is operating. Baiden (2011) claims that factors affecting the specific industry will be important to analyse in an initial credit decision. However, he also recognises that Conditions are difficult to evaluate since the factor is hard to quantify. D'Aveni (1989) further claims that uncertainties about a borrower's future makes it hard for the bank to decide whether or not to continue supporting a company in distress.

Capacity

Capacity concerns the borrower's ability to generate future cash flows that can be used to repay the debt. Since collection of outstanding loans is a vital part of a bank's business, Baiden (2011) argues that Capacity should be carefully evaluated before granting credit to new customers. Capacity is primarily reflected through financial measures. Such information was found to be especially important in the credit granting process for medium sized firms, in the study performed by Danos et al. (1989). Kwok (2002) also concludes that financial information, and especially cash flow statements, is important in the decision to grant new credit for the Hong-Kong-based loan officers in her study. In a slightly more recent study, Berry and Robertson (2006) compare how the use of accounting information in British loan officers' initial credit decisions have changed during 20 years, comparing their conclusions with the findings of Berry, Citron, and Jarvis (1984). They see that information on cash flows has increased in importance and is found to be one of the most important factors in the decision to grant initial credits.

Collateral

Collateral, such as real estate, is in many cases used to secure the loans. Berger and Udell (1990) study American banks and find that collateral is primarily used as a means to reduce the bank's risk exposure. Baiden (2011) shares a similar view and acknowledges that collateral can be used to offset weaknesses in the other C's. However, he also warns against relying too heavily on collateral, as events impairing the capacity during financial distress oftentimes also impair the value of the collateral.

There are several researchers who have investigated how Collateral influences the bank's behaviour when a borrower undergoes financial distress. Nevertheless, the views are not unison. One argument brought forward is that banks with secured lending will be more prone to withdraw their credits. However, most of those studies (see for example Agarwal, Barniv and Leach, 2002; Gilson, 1990 and Bulow and Showen, 1978) focus on an American setting, where the distressed company has both bank debt and public bondholders, and credits often are withdrawn due to negotiation issues between the lenders. Jostarndt and Sautner (2010) reach a similar conclusion but based on German data. Also in this case, the lending was dispersed.

Other researchers reach opposing conclusions. For example, Franks and Sussman (2005) find no support for the idea that British banks, lending money to small- and medium sized companies, liquidate the firms if they are secured. Fischer and Martel (1995), studying Canadian firms in distress, find that secured debt increases the chances of a firm surviving distress because secured claimants, have a greater insight into the company and thus, better knowledge regarding the future outlooks of the firm. Elsas and Krahnen, (2000) also find that collateral increases the chances that a company survives financial distress. Focusing on German companies with strong relationships to their main lender, the authors show that collateral is positively related to banks actively trying to normalise the borrower's distressed state.

Capital

Capital refers to the equity investments made by the owners. Capital is described by Beaulieu (1994) as a reserve for unforeseen problems; highlighting the importance of Capital when the company is in financial distress. Baiden (2011), discussing the Five C's from a theoretical viewpoint, argues that a strong equity position will ensure that the owners of the enterprise remain committed to the business when times are bad; thus reducing the risk of moral hazard.

2.1.2 Additional factors found to have an impact in distressed settings

In addition to the Five C's of credit, a number of additional factors have been found to have an impact on how banks treat customers in financial distress. First, we discuss the relationship between the borrower and the bank, as it has been found to be of importance by Boot (2000). Following, we discuss the bankruptcy legislation as well as the bank's reputation; factors that have been found to be influential by Couwenberg and De Jong (2006) and Moussu, Troege, Europe and Refi (2013) respectively.

Relationship

The relationship between the bank and its distressed customer is identified by Boot (2000) as an important factor in the bank's decision to terminate or retain the relationship with a distressed company. It is likely to be especially important in a Swedish setting since Swedish banks engage in relationship banking (Gunnarsdottir and Lindh, 2011). Relationship banking is described as bank lending that primarily relies on proprietary "soft information" (Udell, 2008). Soft information is qualitative information that is acquired over time through a multiple of interactions with the customer (Boot, 2000). As opposed to relationship banking banks can use transactional lending, which is based on portfolio risk (Allen, Delong and Saunders, 2004).

In relationship banking, the relationship between the bank and the borrower is seen as a mutual commitment based on trust and respect (Boot, Greenbaum and Thakor, 1993; Boot, 2000). In addition, Blackwell and Winters (1997) see that firms with which the bank has close relationships are less frequently monitored due to this trust. Also, is has been found that credit is more readily available for firms with long relationship with the bank (Cole, 1998; Petersen and Rajan, 1994) and that the collateral requirements decrease with the duration of the relationship (Petersen and Rajan, 1994; Berger and Udell, 1995).

A number of articles investigate the impact of relationship banking when the borrower is in financial distress. Elsas and Krahnen (2000), focusing on German relationship lenders, find that long-term relationships allow the banks to better foresee financial distress since they have access to more timely information. Thorburn and Strömberg (1996) argue that particularly Swedish banks, who have close relationships with their borrowers, should be well informed about the financial state of the firm and therefore be able to take actions at an early stage of financial distress. Another advantage of relationship banking is found by Petersen and Rajan (1995). The authors study small American companies and find that in cases where relationship banking is prevailing, the banks oftentimes accept short-term losses in order to assure long-term profitability. Thus, relationships at least partially protect the borrowers from being liquidated due to withdrawn credits.

Moreover, previous research also identifies potential drawbacks with relationship banking. Allen, DeLong and Saunders (2004) argue that, since relationship banking is based on soft information, there is room for subjective judgement in the credit decisions. Two other problems associated with relationship banking are the soft-budget constraint and the hold-out problem. The first problem concerns the bank's ability to terminate the credits when a borrower is in financial distress. Boot (2000) argues that if the bank has a close relationship with a customer, there is a risk that it will be reluctant to pull out of the relationship and recognise losses. The borrower, realising that the bank does not want to terminate the relationship, might then demand opportunistic write-downs of the debt (Bolton and Scharfstein, 1996; Dewatripont and Maskin, 1995). However, this problem can be mitigated by granting seniority to the lender; thus, allowing it to credibly threaten to withdraw its credits (Boot, 2000). The hold-out problem concerns informational advantages that are attained by the bank during the evolvement of the relationship. This information monopoly can create a lock-in effect for the borrower and might result in worsened loan terms as time goes by (Boot, 2000).

Bankruptcy legislation

Bankruptcy laws differ widely between countries and, as brought forward by Jostarndt and Sautner (2010), the outcomes of financial distress are dependent on the characteristics of the specific legal system. As noted by Thorburn and Strömberg (1996), most of the previous studies regarding the banks' treatment of companies have an American setting. As a consequence, this is likely to affect the conclusions drawn from those studies.

In the US, most companies file for Chapter 11 of the US bankruptcy code (commonly known "Chapter 11"), which is a court-supervised reorganization. The aim is to reduce the debt-burden of the distressed company so that it can continue as a healthy going concern (Gilson, John and Lang, 1990). The situation in Sweden is however different. The Swedish bankruptcy code is a cash auction-based system where bankrupt companies are sold either in parts or as a going concern (Thorburn, 2000). As opposed to the US, where companies most often continue their operations following the reorganization, Swedish bankrupt companies cease to exist as legal entities following a bankruptcy (Hotchkiss, John, Mooradian and Thorburn, 2008). Bankruptcies also lead to losses for the banks: on average 69% of the face value of the loan is recovered in a Swedish bankruptcy (Thorburn).

In addition to bankruptcy, Swedish insolvency regulation also makes it possible to apply for formal restructuring, a process similar to Chapter 11 (Strömberg and Thorburn, 1996). According to Hotchkiss et al. (2008), formal restructurings are not seen as an alternative to filing for bankruptcy in Sweden and is therefore used less frequently than the American counterpart (Strömberg and Thorburn).

Couwenberg and De Jong (2006) show that the regulatory setting in the Netherlands, a system similar to the Swedish bankruptcy system, affects banks' behaviour when their borrowers are in financial distress. They see that in such a creditor-oriented system both banks and owners have an incentive to reach an informal agreement and restructure out-of-court, since the bankruptcy system is biased towards liquidation. Also Franks and Sussman (2005), focusing on a British setting, find that the specific legislation system studied favours informal restructurings. In such a situation, the bank and the owner together agree on how to get the company out of distress, without the involvement of a court. Opposing results are found by Jostarndt and Sautner (2010) in their study of distressed German companies. They argue that German companies in distress often use bankruptcy as a restructuring tool due to institutional biases and negotiating issues in the case of many lenders.

Reputation

The bank's willingness to attain a certain reputation has also been found to affect how it treats customer in financial distress. In a recent paper, Moussu et al. (2013) develops a model that depicts how reputation affects banks focused on relationship banking. The authors shows that reputation is fundamental for the bank to be able to establish mutually beneficial financing relationships. Moussu et al. argue that this is especially true when it comes to financial distress, as companies prefer banks with a reputation of supporting distressed borrowers. A similar conclusion is drawn by Chemmanur and Fulghieri (1994), who model the choice between public debt and bank loans. The authors argue that lenders will avoid terminating the credits of a distressed customer since it would be negative for their reputation. This is because other firms look for "sound lenders" when raising debt; banks they know will support them also during bad times.

2.2 Actions

In a relationship banking setting, such as Sweden, the relationship between the borrower and the bank has been shown to impact how the bank treats a company in financial distress (Boot, 2000). However, Li, Lu and Srinivasan (2013) highlight that most previous researchers focus on transactional lenders. For that reason we will highlight whenever the author focuses on relationship banking.

Financial measures

Asquith, Gertner and Scharfstein (1994) describe two responses that banks can take when their customers undergo financial distress. Banks either "loosen" the financial constraints, by e.g. providing new financing, or "tighten" the financial constraints by e.g. accelerating interest and principal payments. The authors, who study distressed American companies, find that banks are more likely to loosen the financial constraints if they are protected by collateral or if the company is judged to be in a temporary downturn. In their study of large, Swedish bankrupt companies, Strömberg and Thorburn (1996) find that prior to bankruptcy, the banks prefer to loosen the financial constraints rather than tightening them.

According to corporate finance theory, distressed companies should be charged higher interest rates due to the increased level of risk (see for example Berk and DeMarzo, 2013 or Koller, Goedhart and Wessels, 2010). However, this is not always observed in reality. Relationship banks have been found to be more likely to assist distressed companies in times of need, primarily through decreased loan rates (Degryse, Kim and Ongena, 2009; Elsas and Krahnen, 1998). Franks and Sussman (2005) find similar results for British, non-relationship banks while Strömberg and Thorburn (1996) find several cases where Swedish banks forgive interest payments altogether. Contrary to these findings, Li, et al. (2013) find that American banks increase the interest rate, also for distressed companies with which the banks have good relationships.

In addition to decreasing the interest payments, banks can extend credits in order to remedy the liquidity shortages of the distressed companies. Elsas and Krahnen (1998) and Peek and Rosengren (2005), focusing on relationship lenders, find that banks often extend the credit to distressed firms in order to help them recover. While Peek and Rosengren find that Japanese banks only provide additional credit to the most severely distressed borrowers in order to keep their own balance sheets unimpaired, Elsas and Krahnen see no sign of such incentives existing within German banks. Contrarily, Li, Lu and Srinivasan (2013) see that American banks seldom provide additional credit to distressed customers, even to the ones they have good relationships with. Similar conclusions were reached by Franks and Sussman (2005) in their study of British non-relationship banks. They find that the banks in their study rarely extended the lending but instead reduced it.

Several authors discuss whether lenders ever forgive the principal amount or parts of it. For example, in the Netherlands, UK, Sweden and US, debt forgiveness has been found to practically never occur, (Couwenberg and De Jong, 2006; Franks and Sussman, 2005; Strömberg and Thorburn, 1996 and Asquith et al., 1994) while it is the most common action that German banks take (Jostarndt and Sautner, 2010). Banks normally have secured claims and therefore have little incentive to forgive the principal, according to Asquith et al. (1994). The authors argue that banks will postpone amortisations and interest payments instead of reducing the face value of the loan; something that would enable the company to survive without reducing the banks claim. James (1996) reasons that secured bank lenders are unlikely to make any concessions, such as writing down debt, unless their claims are impaired; something that only occurs when the borrowers are in severe financial distress.

One extreme way for banks to deal with distressed companies would be to withdraw the credit altogether. Nini, Smith and Sufi (2009), Couwenberg and De Jong (2006) and Brown, James and Mooradian (1993) all argue that if the bank decides to call the loan, the company is likely to be forced into bankruptcy. Franks and Sussman (2005) and Brown et al. find that, although the bank has the main power to liquidate a company, it usually tries to rescue the firm first. Nini et al. argue that while banks seldom choose to withdraw the credits, they use it as a threat in order to influence the company's decision making.

Operational measures

Couwenberg and De Jong (2006) look at how Dutch banks treat non-listed, small- and medium sized borrowers when they undergo financial distress. They aim to investigate what actions lead to successful out-of-court restructurings. Their results suggest a positive correlation between when banks actively take actions and the success of the restructuring. In addition, the authors find that operational measures are of greatest importance if the restructuring is to succeed or not. Franks and Sussman (2005) also find support for British banks engaging with distressed companies operationally, although they do not offer as extensive description of the actions taken.

Nini, Smith and Sufi (2012) study what happens to American listed firms after they have violated covenant agreements. The authors conclude that creditors increase their control over the company's corporate governance when these violations occur, even though the borrower may not be in danger of defaulting on its loans. They also find that American banks influence their borrowers in taking on more restrictive financial and investment policies and how to best run their business. This includes selling off assets, delaying dividend payments and decreasing capital expenditures. Additionally, Nini, et al. (2012) and Ozelge and Saunders (2012) record increased CEO turnover when firms undergo financial distress, something that is interpreted as the creditor's deed.

Similar to Nini et al. (2012), Couwenberg and De Jong (2006) identify that banks take actions such as developing the borrower's strategy, reducing its cost base, selling off assets and changing management. Interesting to note is that while Couwenberg and De Jong do not provide any suggestion of when the banks take these actions, Nini et al. find that banks engage in the borrowers' decision making as soon as the first covenant has been violated.

Converting debt to equity & capital injections

Couwenberg and De Jong (2006) explain that when a company is severely distressed, banks may engage in exchange offers, whereby they write down parts of the debt and get equity in return. However, the authors did not find this action to be commonly used. Franks and Sanzhar (2004), studying British companies, conclude that banks avoid equity holdings in unlisted companies due to the low liquidity of the investment. They therefore claim that this action only occurs when the borrower is large and publicly listed. Similarly, Jostarndt and Sautner (2010) find that equity holdings are uncommon in German unlisted companies due to regulatory and legal reasons.

While it seems to be uncommon that European banks take equity, Gilson (1990) finds that it frequently occurs in American restructurings of publicly listed companies. James (1995), who also focuses on the American market, argues that secured creditors such as banks will never take equity if liquidation renders the highest value of a firm's assets. He also finds that banks only take equity if other claimants also make concessions since it otherwise would be a wealth transfer from the banks to other claimants. This is similar to Diamond (1992) who argues that, since banks often have secured claims, they are unlikely to make concessions and take equity if someone else will benefit from it. James (1995) also finds that the likelihood of a bank taking equity in a certain company is positively related to the firm's growth opportunities. Also, he finds that the likelihood increases as the value of the borrower's assets decreases; a sign of the distress becoming more severe.

One of the few articles discussing equity investments made by the owners is Couwenberg and De Jong (2006). They find that shareholders contribute with new funds in only 20 percent of the distressed companies studied. The reason for this low figure is that the owners often are limited to do so because of wealth constraints. However, the authors do not find that firms are more likely to survive financial distress if the equity holders are able to invest additional capital.

3. Theoretical framework

The theoretical framework, being twofold, will be used as a tool to analyse our findings in section 6. Analysis. In the first part, we define the factors that we expect to affect how the banks treat companies in financial distress. In the second part, we tie the banks' actions to the enterprise value of the borrower and make a schematic illustration of when and why banks take certain actions (labeled Value-break).

3.1 Factors affecting the bank's decision to terminate or retain the relationship with a distressed customer

Below follows our definition of the factors that have been found from previous research to have an impact on the bank's decision. The factors will be used as a basis for our analysis.

Capital	The equity investments made by the owners
Character	The trustworthiness, integrity and commitment of owners and management
Conditions	The economic conditions of the market and industry in which the company is operating
Capacity	The company's ability to repay its debt by generating cash flows
Collateral	The amount of collateral that is protecting the bank's claim
Relationship	The bank's relationship with the company
Bankruptcy legislation	Swedish Bankruptcy law and how it is used in practice
Reputation	The reputation of the bank

3.2 Value-break

The value-break will be used in the analysis in order to understand when, how and why the bank acts in certain ways. It is expected to be especially useful in analysing situations where the bank retains the relationship with a distressed firm. We have developed the illustration on the next page (Figure 1) to schematically depict this concept. It is based on insights offered by previous research and interviewees, as well as our own analytical intuitions. In essence, the value-break shows the risks held by the bank, the owner and other claimants. When the enterprise value of the borrowing firm decreases, the equity and debt investors will become impaired. At first, at a), only equity is impaired while at c) senior debt is the only claimholder that remains.

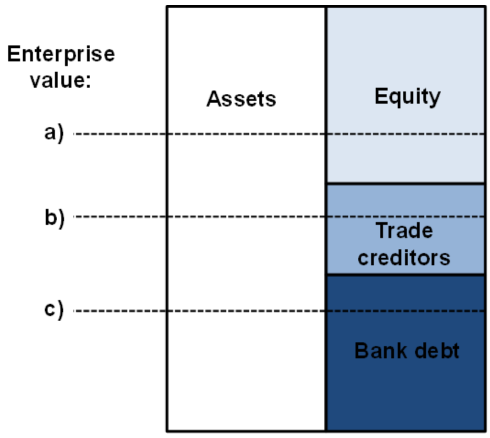

Figure 1. Schematic illustration of the value-break - depicting the value of the company and what claimants are impaired.

The level of impairment is believed to influence the claimants' motivation to take certain actions. At an early stage of the financial distress, at a), the bank does not need to act forcefully, since only equity is impaired. According to Couwenberg and De Jong (2006), banks might adopt a "lazy" attitude in such a situation, especially if there is collateral protecting the claim. The authors further claim that banks, as a consequence of being lazy, do too little, too late.

The more distressed the company is, and the closer the bank's own position is to impairment, the more forcefully it will have to act in order to avoid credit losses (Baird and Rasmussen, 2006). While creditors are traditionally thought to remain passive for a long time when a company is in distress (as described by Hart and Moore, 1998), Nini, et al. (2012) argue that banks take action much earlier than the traditional view.

Equity holders' incentives to act will also be affected by the value-break. As long as equity still has a value, at a), the owners will strive to increase this value. The more distressed the value of the company, and the lower the fair value of assets, the less incentive equity holders will have to invest additional capital. In case all equity is impaired, investing additional capital would only result in wealth-transfers. If, for example, the owners were to invest more equity at b), it would primarily benefit the trade creditors. The same goes for debt holders. As long as there is equity left, at a), banks will have little incentive to reduce their claims as it would be a wealth-transfer to equity holders.

The value-break might also influence the real power the bank has to demand certain changes (Baird and Rasmussen, 2006). The lower the value-break, the more decision-making power shifts from equity holders to debt holders. At point c), the claims of all the other investors have been wiped out and only the bank remains. At this stage the bank is the de facto owner of the company, although equity owners still are in legal possession. Given that equity has no value, the owners' holding will work more like an option. The equity investors would benefit if the value of the company increased but have nothing more to lose if the value was to decrease even further. As a consequence, the owners, who still are in charge of the company, might be inclined to adopt a higher level of risk than would be preferred by the other claimants such as the bank.

4. Methodology

In this section, we present the methodology used to conduct our study in order to answer our research questions. Firstly, we explain why a qualitative, interview-based research design serves our purpose and then move on to describe our chosen research approach. Secondly, we identify stakeholders that have an insight into our chosen research area. The parties included in the study are owners, financial advisors, legal advisors, bankruptcy trustees and a researcher. We have chosen not to include the management of companies in financial distress, primarily due to information sensitivity. Thirdly, we describe the process of data collection and data analysis and discuss in what ways we have ensured to obtain openhearted and rich narratives. Lastly, we consider the quality of our research and how we have tried to minimise the potential shortcomings that might result from our methodology.

4.1 Research design

Some research can be found within our specific area of interest, although of quantitative rather than qualitative nature. A quantitative approach would limit the understanding of the results we will find. It would allow for the identification of certain outcomes but not provide any information of why they are occurring. We want to study the interplay between different factors affecting how the banks act when companies are in financial distress, and also understand *why* certain actions are taken. In order to succeed in doing that, Bryman and Bell (2007) and Maxwell (2013) suggest using a qualitative method. Such an approach is beneficial to our study due to a number of reasons, which are explained below.

Firstly, as argued by Maxwell (2013), qualitative research takes into account the setting within which the subjects act. This is essential in our study as we seek to understand the context in which banks make decisions. Also, it allows us to study how this context influences the actions that banks take. That is, if they continue to lend money or not, and what actions that follow when this decision is made.

Secondly, using a case study would have been interesting but the approach was rejected due to two reasons. To begin with, we quickly realised that banks are reluctant to provide outsiders with information regarding specific companies since the information is sensitive. Also, a case study limits the applicability of the results to the single case, or cases, studied. Since the circumstances differ each time borrowers undergo financial distress, a similar study would not be generalisable. Thus, limiting the research to one or two cases would not have served our purpose.

Lastly, Yin (2009), Andersen (1998) and Miles and Huberman (1994) claim that a qualitative approach provides more complete findings as it offers a deeper understanding of the studied phenomenon. The process of banks lending to borrowers undergoing financial distress is a complex and dynamic issue. It involves several stakeholders and can have severe consequences for the borrower. We have therefore, in line with the reasoning of Miles and Huberman, chosen to conduct an interview-based study in order to capture this complexity.

Research approach

To conduct our study, we have applied systematic combining. Systematic combining is an abductive approach that combines established frameworks and new concepts that are found during the study (Dubois and Gadde, 2002). We believe that systematic combining suits the purpose of our study since it "builds more on refinement of existing theories than on inventing new ones" (Dubois and Gadde p 559).

Although Dubois and Gadde (2002) describe that this approach applies for case studies, we believe that it is applicable to our method as well. Firstly, our objectives are similar to those of a case study. Secondly, although we do not use a specific case, we have asked the interviewees to answer our questioned based on a presupposed case that they have been involved in. Lastly, as often is the case for case studies, the main source of data collection has been through interviews.

Systematic combining has provided us with an iterative research process with continuous modification of frameworks used as the process of data collection has progressed. It has also allowed us to investigate unexpected side issues that have surfaced during the interviews and to change or add to our theoretical framework (Eisenhardt, 1989). In practice, this means that we have revised theory and gathered empirics in parallel. The findings in the interviews have guided us in exploring additional research and to refine and redirect our questions in future interviews. This process is similar to the one suggested by Eisenhardt, where data collection and data analysis is overlapping one another. As a consequence, theories and empirical findings have been used in jointness in order to explicate our findings.

4.2 Identifying stakeholders

Banks do not act in isolation but in a network setting; implying that their actions will affect a number of stakeholders. As we wanted our sample to reflect reality, suggested by Dubois and Gadde, 2002, we chose to include several stakeholders. Before any interviews were conducted, we tried to identify all relevant stakeholders for our study. To assure that we had done this properly, we asked each interviewee to provide us with additional people that they thought we should meet. In most cases, these recommendations corresponded well to the list of stakeholders that we had identified beforehand (shown in Figure 2 below). Through combining multiple stakeholders' viewpoints we feel that we have managed to get a complete picture of the situation (see Appendix one for a more detailed presentation of the interviewees).

One stakeholder that was excluded from the study was the borrower: the financially distressed company. We chose to not talk to the management of distressed or bankrupt companies due to the sensitivity of their information and their inability to recollect more than their specific case. Instead we interviewed people with experience from owning several distressed companies. As several of the owners interviewed represented Private Equity companies, who are known to have a close contact with the management of their portfolio companies, we reasoned that they would be able to offer insight into the borrower's situation as well as the owner's.

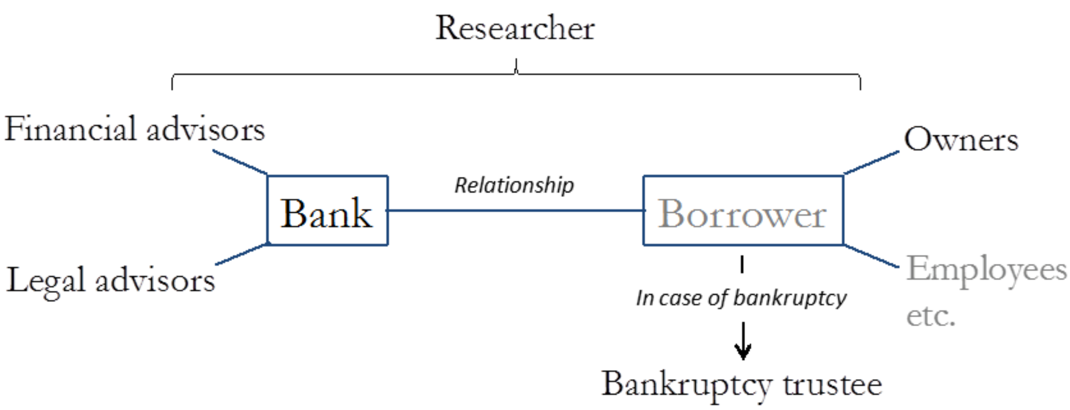

Figure 2. The stakeholders interviewed in this thesis (in black) as well as their mutual relationships.

Banks

As we want our results to be generalisable to the Swedish banking sector, we have deemed it important to include more than one bank in our study. Therefore, we included all four major banks in Sweden: Swedbank, Nordea, Handelsbanken and SEB as well as one smaller Nordic bank. In total we met with 14 employees, of which two work as loan officers, three work with risk, six work with distressed credits and three are responsible for overall credit decisions.

The Swedish banks are organised in somewhat different ways but they share some characteristics. All banks have loan officers that are responsible for the relationship and contact with the borrowers. In addition, Credit committees, consisting of senior professionals, approve of the credits proposed by the loan officers.

While the loan officers handle normal customers, the responsibility of financially distressed companies is typically transferred to work-out teams, solely dealing with distressed credits. Therefore, we have chosen to meet with people from both credit and risk to ensure that we get a comprehensive understanding of how banks handle distressed credits (illustrated in Figure 3 above). Throughout the interviews, we have found that, although the banks are organised somewhat differently, they reason and behave in strikingly similar ways.

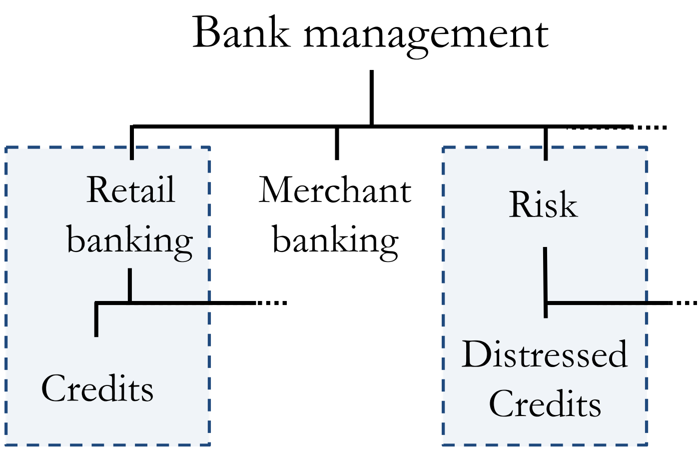

Figure 3. Schematic illustration of the banks' organisational structure. We have interviewed people within the shaded areas.

Researcher – Per Strömberg

Per Strömberg is the SSE Centennial Professor of Finance and Private Equity at the Stockholm School of Economics as well as Adjunct Associate Professor of Finance at the University of Chicago Booth School of Business. Strömberg's research is primarily focusing on bankruptcy and Private Equity finance. (Institute for Financial Research, 2013). As Strömberg has previously studied bankruptcy outcomes in Sweden, he has been able to provide valuable insights to our study. We have also used one of his published papers in our research: Strömberg and Thorburn (1996).

Owners

Owners, who often have invested substantial amounts in their companies, are one of the main stakeholders in the case of financial distress. The four owners that we have spoken to have extensive experience from owning and managing Swedish companies and were able to share insights about the particularities of owning distressed companies. Since many of the owners we interviewed work at Private Equity companies, their business model is dependent on bank financing. They have also dealt with several cases where companies have been in financial distress and close negotiations with the banks have been necessary.

Financial advisors

Financial advisors can provide banks with a second opinion on their decisions or assist in the work-out process. With the help of financials, they perform an analysis and advise the banks in whether or not to continue lending to a borrower in distress. For example, they help banks to assess the forecasted projections of the borrowers or assist in analysing why the company became distressed in the first place. Thus, financial advisors have a good understanding of how banks reason when the make decision and what actions that they are most likely to take.

In total, we have spoken to four financial advisors from different organisations. Some of the advisors had previously been employed by banks; thus being able to offer insights into why the banks act in certain ways.

Legal advisors

Legal advisors often aid banks in the decision to terminate or retain the relationship, especially with regards to the legal procedures. They are often involved in the decision-making and have seen several cases where borrowers have been in financial distress. This is especially the case for the two legal advisors that we have interviewed; they both have long experience from working with distressed Swedish companies. They are also knowledgeable of how Swedish bankruptcy law is written and how it is used.

Bankruptcy trustees

Bankruptcy trustees provide an outsider perspective of how banks treat borrowers in financial distress. They can either represent the bank or the borrower. They are not part of the decision to either terminate or retain the relationship but handle the company after it has filed for bankruptcy. They therefore have an insight into what actions were taken to by the bank prior to bankruptcy and what characterises bankrupt companies. We have spoken to two bankruptcy trustees, both lawyers, who were able to share valuable insights about bankrupt companies and Swedish bankruptcy law.

4.3 Data Collection

Our primary source of data collection has been in-depth interviews, but we have also used external and internal documentation as a complementary source of data. In total, we have conducted 17 interviews and participated in a panel discussion where three industry professionals debated our topic. In total, we have met with 27 different people within 13 organisations. The length of the interviews ranged from 40 minutes to 70 minutes with an average length of approximately 55 minutes. The interviews have taken place during September and October 2013. The number of interviews conducted is considered enough to ensure saturation, as little new information was acquired during the later ones (Eisenhardt, 1989).

The process of data collection was started by a pre-study. In this study, we used the Five Cs of bank lending (Beaulieu, 1994) as guidance in open-ended interviews. The aim of this pre-study was to form an overall understanding of the lending process and the decision-making within the banks. These findings were used during the main data collection, which was carried out by semi-structured interviews with predetermined questions. As Kvale (1997) reasons, the questions differed across interviews as we wanted to generate spontaneous responses. For this reason, the questions where seen as a check-list and there was not any particular order in which the questions were posed.

In order to assure that the interviews were as rich and honest as possible, we followed the guidelines provided by Östman (1977). We tried to establish a conversation-like atmosphere by starting each interview with some time to present ourselves and our study. We also made sure to ask for permission to record the interviews and stress that all responses would remain confidential. After this, they got to talk about themselves to get them comfortable and start off the conversation. The remainder of the interviews focused on our pre-determined questions, but with individual follow-up questions based on the answers given. This allowed us to maintain the conversation-like atmosphere and provided a basis for the interviewees to provide rich descriptions of their experiences.

Moreover, by being well prepared, we were able to pose appropriate follow-up questions in the interviews. Also, it increased the interviewees' willingness to provide their insights of the problem, as they understood that we had prior knowledge about the events that they described. Lastly, as we were able to show that we were well informed about sensitive, and sometimes confidential, data, they were more prone to provide us with additional information.

Östman (1977) argues that the interviews should be based on concrete events, to be able to go beyond abstract clichés. However, we were not able to do this, as the nature of such information is highly sensitive and often confidential. Instead, we followed the suggestion made by Brinkmann and Kvale (2009) and asked the interviewees to answer our questions based on one or several cases they had been working with, without telling us what company they were talking about. With this case as a basis of their answers, they could elaborate on explicit details that were important in the specific setting as well as answering questions of a more general kind.

During the interviews, we also encouraged the respondents to go beyond their first reaction to our question by asking them to exemplify and explicate through questions like: "Can you elaborate?", "What do you mean?", "Why did you do like that?". Also, we tried to summarise what was said in order to get confirmation that we had understood the answers correctly. Another technique that was used was to pose the same question in different ways, in order to see if the answers were coherent. We also contacted the interviewees after the interviews to confirm that we had understood them correctly and they were also asked to approve of our use of citations.

Although this thesis is written in English, the majority of our interviews where held in Swedish given the respondents' backgrounds. This allowed the interviewees to feel comfortable and speak more freely during the interviews. Moreover, since all interviews were held face to face and we were able to study the body language, facial expressions and reactions of the respondents, which facilitated the interpretation of their answers.

After each interview we summarised the key findings individually and then discussed what we had found to be most important. As proposed by Merriam (1988) and Brinkmann and Kvale (2009), we recorded the interviews and transcribed the recordings afterwards. In addition to the recordings, we also took notes and wrote down observations regarding the expressions and body language, which the recording could not capture.

4.4 Data analysis

The data analysis was carried out in two main steps. Firstly, the interviews where looked at as whole texts as suggested by Alvesson and Sköldberg (2004). According to them, such an approach allows the researchers to go beyond the surface and to see the material in its context. The second step followed Miles and Huberman's (1994) procedure of analysing qualitative data:

1. the notes from the interviews where coded,
2. reflections were continuously written down,
3. patterns and discrepancies were searched for and isolated to assist further data collection
4. generalisations that were found in the data was elaborated and,
5. these generalisations was contrasted to established knowledge and theories.

The data was coded into main themes: factors influencing the banks' decisions, actions that are taken as well as background information that is important for the context. Our theoretical framework provided a basis for these main concepts, especially the Five Cs of credit (Beaulieu, 1994). Using predetermined codes helped us in structuring the analysis, as it was easy to find factors that were outside the scope of existing theories and that had to be added to our theoretical framework (Miles and Huberman, 1994). However, when coding the first interview, we extended the codes to include other factors, such as regulation, accounting and media. We continued to add codes as we found new things that were not covered by our initial set of codes. Thereafter, the coding was cross-checked in order to reassure that we agreed on the coding. In the majority of the cases we agreed on the coding, while in some cases we did not agree. In these cases, we discussed the coding in order to agree on the appropriate code.

Once the coding was in place, we set down to analyse each code in isolation. We discussed, searched for patterns, discrepancies and contrasts. As we interviewed different stakeholders, we were able to look at differences across the groups in order to understand what group of interviewees shared a certain opinion. This assisted us in contrasting some of the arguments posed by either one of the groups. We isolated the answers given by the banks, and compared them with the ones of external stakeholders to see if they differed or was in unison. We found that in most cases they had a unison view, although the advisors, as might be expected, had a more critical view of how the banks behaved.

4.5 The quality of the study

Our choice of method will have consequences with regards to our study's reliability - the ability to reach the same conclusions by replicating the study (Yin, 2009) - and its validity - the extent to which our results can be considered to represent reality (Merriam, 1988). The following section therefore accounts for potential limitations that might threaten the quality of our results and also explains how we have set out to mitigate them.

Reliability

Since our study is based on interviews rather than documentation of procedures, our results will be an effect of the interviewees' recollection of things, which in turn might be influenced by subjective bias. In addition, a negative consequence of the semi-structured format of the interviews might be that we, the interviewers, influence the answers provided since the format allows for an interplay between the interviewer and the interviewee. Thus, another interviewer might have received dissimilar results.

We have tried to minimise errors and subjective bias. Firstly, we made sure to establish a predetermined plan on how to conduct our study. Such forethought is considered to enhance the reliability of the study (Yin, 2009). Secondly, all interviews were conducted face-to-face, with both authors present. We also made sure to discuss our impressions and ask for clarifications, in order to reduce any misinterpretations. Thirdly, Yin (2009) and Maxwell (2013) suggest that extensive documentation will increase the reliability of a study. We therefore ensured to record, transcribe and subsequently code all interviews. In addition, we took notes during the interviews, individually summarised our findings after each interview and then discussed our conclusions afterwards. We had also the possibility to ask clarifying questions to all interviewees after the interviews had taken place.

Lastly, as we only have met with a limited amount of people in order to conduct our study, the results might be biased (Alvesson, 2003). However, we have tried to limit this by meeting with several different Swedish banks. In addition to the insights provided by the banks, several of the other professionals interviewed had many years of experience of working in and with Swedish banks, which allowed us to validate our findings across organisations.

Validity - construct, internal and external

Validity can be conceptualised into three different areas: construct validity, internal validity and external validity (Yin, 2009). Construct validity refers to the use of appropriate measures when conducting the study (Yin, 2009) and if it succeeds in measuring what it is intended to (Bryman and Bell, 2007). In order to assure high construct validity, we have followed Yin's proposed measures. Firstly, we have tried to establish a chain of evidence - to clearly show how we have come to our conclusions. This chain has been established by the use of a database in which our research questions, data collection, data analysis and conclusions were recorded. Secondly, we allowed the interviewees to review citations and drafts of our report during the process, in order to minimise the risk of misinterpretations and to allow for a discussion of the underlying logic. Lastly, we have aimed to use several sources of data collection such as internal documents, credit scoring models and annual reports as complements to the interviews to allow for triangulation. However, most internal sources were hard to get access to due to the sensitivity of such information. Instead, we tried to validate our results across different organisations to make up for the limited use of additional data sources.

Internal validity concerns whether or not the results can be generalisable to other organisations within the setting (Maxwell, 2013). The level of internal validity refers to whether the respondents express their true opinion and if the researchers are able to understand them correctly (Merriam, 1988). In order to increase the likelihood of obtaining candid and rich answers, we have followed the method suggested by Östman (1977) to conduct our interviews. In addition, we have included numerous banks and several stakeholders so that we could validate our results across organisations and reduce the likelihood of getting a biased view of the situation.

In contrast to internal validity, external validity concerns the generalisability of the findings to other contexts (Eisenhardt, 1989). This is one of the most criticised areas of qualitative research, as one could question if our findings simply are illustrations of an extreme case or an ideal type (Maxwell, 2013). One of the problems arising when using a qualitative method is that we cannot rely on statistical inference to draw conclusions, but rather have to rely on analytical inference. Since our results will not be statistically generalisable, the conclusions we can draw will be limited. Instead of testing the validity of existing theories, we strive to generalise a particular set of results by using broader underlying theory. To be able to make such generalisations, statistical inference is not as important (Merriam, 1988), why a quantitative methodology can be considered appropriate (Becker, 1991). A measure taken to increase the external validity is to extensively compare and contrast our findings with existing theory (Maxwell, 2013). By using our theoretical framework as a guide when analysing our empirical data, we have thus been able to increase the external validity of our study to some extent.

5. Empirical findings

In this section we describe the empirical findings of our interview study. The findings are divided into four sections. We start with a background to Swedish banking and we continue by accounting for how continuous screening processes and covenants are used to identify distressed borrowers. Here, focus lies on what make banks act late. This is followed by a description of how banks evaluate their situation once the distressed borrowers are identified and especially how relationship banking complicates their decision to act or not. Lastly, we account for actions that the banks take, either when terminating or retaining the relationship and why they choose certain actions.

5.1 Swedish banking

Business model

> "We are concerned about our owners' money. The banks of today; we are not non-profits. We are not doing this to please someone; we are doing this to make money. It's as easy as that" (Head of credits 1).

Swedish banking is a low-margin business: the interviewees were in unison that in case a customer was to default on its loan, a vast amount of new customers would have to be enlisted to cover the loss. "If you lose the entirety of one loan, the margin you make of another 50 or 60 or maybe even 90 loans is gone" (Financial advisor 1). For this reason it is important for the banks to avoid credit losses. Measuring and controlling for risk is also a natural part of the banks' business since they are required to hold a certain amount of capital in relation to the riskiness of the asset (Loan officer 2 and Loan officer 1). For this reason, it was argued that, "banking is not made for taking risks" (Head of Credits 1).

One way of controlling for the risk is to thoroughly evaluate potential customers before deciding to lend them money. When choosing whether or not to grant initial credits to a loan applicant, the bank carries out an internal credit screening similar to rating systems developed by Standard & Poor's (Head of Credit Committee 1). This is also valuable in the future as the bank gets to know their business.

> "We must understand the company's business. If we do not understand their business model we are not going to be a good partner to them" (Head of Credits 1).

Customer relationships

> "Long-term relationships with our customers are one of the cornerstones of our operations. Since [the bank] was founded, we have provided advisory services and financial solutions to aid our customers to fulfil their goals" (SEB, 2012 p. 2).

A main pillar in the business model of Swedish banking is strong relationships with the customers. This focus is also evident throughout the interviews. Head of Credits 1 stressed that they "aim for lifelong relationships", something that was further elaborated on:

> "It is like a marriage. You want a partner you can be with for life. You build trust over time, which creates a relationship that you want to keep" (Head of Distressed Credits 3)

> "It is a partnership, we are not like any other supplier. It is important that the customer understands this" (Head of Distressed Credits 1).

When asked why such a relationship is important the answer was simply: "we want to make money" (Head of Credits 1). Since the services provided by the different banks are similar, the relationship is a way to differentiate the offering. In fact, borrowers tend to stay loyal to their bank and seldom switch:

> "It is extremely rare that a new customer comes knocking on our door. If this happens, it is most often because they are experiencing difficulties with their existing bank relationship" (Head of Credits 1).

5.2 Identifying distressed borrowers

All interviewees agree that the sooner the bank discovers that a customer is facing financial difficulties and acts on in, the better. However, they also stress that it is not an easy task to find these companies early on. Loan officer 2 explains that this is because the owners oftentimes do not realise the severity of the situation or are afraid of telling the bank that something is wrong. Moreover, banks are simply not able to keep track of all their customers as they are "large organisation[s] with a lot of credits" (Head of Risk 2), where "every loan officer is responsible for many customers" (Head of Distressed Credits 4). While screening processes are carried out on a regular basis, all companies in distress simply cannot be identified (Financial Advisor 3).

Covenants are common in credit agreements as a way of monitoring that the company stays within the desired level of risk. If these covenants are breached, the banks often have the right to withdraw the credits. "If the borrower violates a covenant, something is clearly wrong" (Head of Distressed Credits 3). Although the company is in technical default when a covenant is violated, it is exceptionally rare that the bank terminates the credit the first time a covenant is breached (Head of Risk 2). Actually, banks tend to refrain from taking action until covenants have been breached several times:

> "If you notice that a borrower violates a few [covenants], then something is wrong. Banks often think that covenant violations are not interesting to deal with. Therefore, they perform little analysis at this point. Instead, they tend to trust management's beliefs that the downturn is temporary and that it will soon improve. So they wait." (Legal Advisor 1).

> "Banks think like this: the borrower might be in breach under the agreement, but they claim that sales next quarter will be much better. As a consequence, banks do not take the unpleasant decision but instead hope for improved performance" (Financial Advisor 3).

Few of the loan officers seem to consider violation of covenants to be severe: "covenants are breached all the time" (Head of Credit Committee 1) and "it occurs also to healthy and well-kept companies" (Head of Distressed Credits 4). However, this behaviour is criticised by Legal Advisor 1:

> "Generally speaking, I think that the banks keep their customers too long. At least they let them try to solve their problems on their own for too long. I sincerely believe that they [the banks] should act earlier. I think that the error most often committed by the bank, is that they do not take covenant violations seriously."

When a company finally has been identified as in distress, it often takes a while for the bank to take action. As a consequence of the strong relationship, the bank often trusts in the customer's capabilities:

> "It is the same as with many long relations; you become passive since it has worked out well the last 20 years. And you have had similar ups and downs before so it probably will not get any worse this time. […] so [the banks] hope too much. They are not objective enough. It might sound simple but I do not think that it is any more difficult than that" (Bankruptcy Trustee 1).

5.3 Evaluating the situation

Understanding the viability of the borrower

Most interviewees agreed that firms most often enter financial distress because their cash flows are inadequate. The borrower's ability to repay its debt is low and therefore, the company's credit rating has deteriorated. Instead of relying on the credit rating, the bank tries to understand the future prospects of the company and its ability to generate future cash flows. According to Head of Distressed Credits 2, the bank tries to understand questions like:

> "Is there a future for this company? Is there a potential to earn money in this industry? Is it a temporary downturn or will the market for these product disappear?"

If the bank concludes that the future of the company looks grim, it is likely that the bank will try to get out of the relationship as quickly as possible since it is considered a lost case:

> "If you are the best ice block manufacturer it does not matter how good you are when the refrigerator is invented" (Financial Advisor 1).

He further argues that if, on the other hand, the business model is considered viable, the bank is most likely going to make an effort to keep the company afloat in order to avoid credit losses. However, this is not an simple task and all industries are not as easily identified as bad as ice block manufacturers:

> "It is a subjective decision. We are talking about a future that no one knows anything about. Instead, we must assess: do we trust the owners? Do we trust management?" (Distressed Credit Manager 1).

Understanding the risk held by the bank

In parallel to determining the long-term viability of a customer in distress, the bank evaluates its collateral in order to understand how much value would be lost in case of default (Head of Distressed Credits 4, Head of Risk 1 and Head of Risk 2). If the value of the collateral is high in relation to the loan, the interviewees argue that the bank will act in one of three different ways: collecting the collateral, actively putting pressure on the company or being passive:

> "If you are a senior debt holder and you have collateral to secure your claims, then it might be more reasonable to push the borrower into bankruptcy" (Strömberg).

> "[...] if the bank believes that the value of its collateral is high, it can be rather cocky. In that case, the bank is not scared of the situation" (Legal Advisor 1).

> "The banks will be more passive as they believe that they are secured. It is very, very rare that banks realise their claims" (Bankruptcy Trustee 1).

> "If we believe that we will not lose any money, we can ease the burden. We will not be wearing the boxing gloves from day one. We can be rather reasonable, as it does not matter to us in the end" (Head of Credits 2).

In contrast, if the value of the collateral in relation to the loan is low, the situation will be completely different. Legal Advisor 1 claims that, in such a situation, the bank will take a much more active role in assuring that as little money as possible is lost. This claim is maintained by Head of Credits 1:

> "We made the assessment that if this company files for bankruptcy, we will lose the entirety of our claims. It will be necessary to make some concessions in order to save the borrower. In case we would have had adequate collateral, we probably would not have acted at all."

While the banks might believe they are protected by collateral, Bankruptcy Trustee 1 criticises the banks for frequently overestimating its value. Head of Distressed Credits 3 agrees that he and his colleagues seldom know the true value of the collateral. He claims that banks perform their own analysis of the value of the collateral only when the company is close to default and, at that stage, they often find the value to be lower that they previously thought.

Existing relationships affect the bank's actions

The existing relationships will affect how the bank acts when a company is in financial distress. As said by Legal Advisor 2: "I think that the most important thing is the customer relationship – Swedish banks want to keep their customers happy." The importance of sustaining good relationships is also highlighted in the banks' annual reports:

> "We put a pride in keeping our promises" (Swedbank, 2012 p.7)

> "We are a decentralised bank were the basis for our operations is to act in the customers best interests" (Handelsbanken, 2012 p. 60)

> "We always think and act to assure our customers best interests" (Nordea, 2012 p.10)

According to Head of Credit Committee 1, a loyal customer can expect to be better treated if in distress: "Of course, if you have had a company 30-40 years and they have always behaved well and tried to do their part, no squabble and no fuss, then you make an extra effort." Several interviewees elaborated on the same argument and explained that it is harder for the bank to take a stricter position if it has a good relationship with the company. For example:

> "They have managed similar situations in the past. Who am I to say no if they want to give it a try?" (Head of Distressed Credits 5).

> "[In a distressed situation] it is important that we have confidence in each other, that we trust the capabilities of the owners, management - the ones running the company - and their ability to get the company back on track" (Head of Credits 1).

Preferential treatment of the borrower presupposes that the company shows that it values the relationship through having an honest and open communication (Financial advisor 3). However, if the relationship is bad, borrowers might expect a completely different treatment. For example, Head of Distressed Credits 3 claimed, "if there is no trust there will be no collaboration". Head of Credits 2 further described this:

> "If it is a person that has acted hostilely and dishonestly, then we will be a bit tougher [...]. Then we say that we cannot consider continuing this relationship because this person is not serious. And sometimes it might cost us some extra credit losses."

5.4 Actions taken by the bank

5.4.1 Terminating the relationship

The interviewees mentioned three alternatives when it comes to ending a relationship with a distressed customer: selling the debt to another player, terminating the credit or filing for bankruptcy on behalf of the distressed borrower.

Selling the debt

> "Never. We do not sell our credits" (Head of Distressed Credits 2)

All interviewees agree that it is highly unusual that a Swedish bank will sell a part of its loan book (unless part of a syndicate). It is argued that terminating the relationship by selling the debt would both be disrespectful to the customer and result in lost future revenues. Head of Risk 2 explains:

> "We are a retail bank. We don't trade in, what do you call it, distressed assets. […] I think it has to do with the customer relationship. We are working very close to the customers and we are a long-term partner."

Investor 2 brings forward a similar argument: "You do not trade in the loan book that easily if you have a long-term relationship with the customer, because it would be disrespectful."

Another reason for why banks do not sell their claims is related to the financial accounting. Swedish banks report in accordance with IFRS[2] and thus, record loan receivables as held-to-maturity investments[3]. The loan will only be written down if "there is any objective evidence that a financial asset […] is impaired" (IAS 39 §58). While the bank employees all claim to account for losses as soon as possible, it often takes a while until they are recognised. For example, Head of Distressed Credits 5 withheld:

> "We had no idea if we would get our money back, but the loan was never impaired in our books."

Throughout the interviews, it became apparent that oftentimes, the loan book is actually not impaired until the borrower files for bankruptcy, when there is a contractual agreement to write down the claim, or when the loan is sold. As a consequence, banks do not want to take any actions that will force them to recognise losses.

> "Banks are not incentivised to write off their loan book under the capital adequacy rules in CRD4, Basel III, and abide by the devise: 'as long as there is life, there is

[2] International Financial Reporting Standards www.ifrs.org

[3] At recognition, the banks value the asset at fair value and then subsequently at amortized cost less any principal repayments, cumulative amortisation using the effective interest method and minus any reduction for impairment or uncollectability (IAS 39 §9).

> hope.' That is, as long as the borrower pays its interests there is hope to get the principal back and hence no provisioning is needed" (Investor 3).

> "You do not want to [sell the claim] because it forces you to realise a credit loss. There is no research proving this but you hear people in the market saying that it is hard to make banks dispose of their loans due to this" (Strömberg).

This behaviour is "completely opposite to the US where, […] under the Sarbanes Oxley act, a loan that is non-performing must be written off or written down", according to Investor 1. He argues that American banks for that reason are more willing to sell their underperforming loans.

Filing for bankruptcy or formal restructuring

Bankruptcy is not popular among the banks: "the last thing they want to do is to put it into reconstruction or bankruptcy" (Financial advisor 1). According to Head of Distressed Credits 2 bankruptcy only occurs "if we have not found a sustainable solution". Most interviewees agree that bankruptcy is seen as a failure:

> "Game over" (Head of Distressed Credits 4).

> "In Sweden we think bankruptcies are really scary. It is a last resort" (Head of Risk 2).

> "Bankruptcies are seen as failure in Sweden but I do not know why. For example, you are seen as an entrepreneur in Norway if you have been part of a bankruptcy whereas it can be detrimental for your reputation in Sweden" (Investor 1).

However, according to Investor 2, the banks want to avoid having a company file for bankruptcy because of other reasons: "they know they are more unlikely to get all their money back." Even though generally perceived as negative, several of the interviewees also recognize that bankruptcy in some cases can be used as a restructuring tool (Legal Advisor 1, Head of Credits 1, Head of Distressed Credits 2 and Head of Distressed Credits 4). If bankruptcy is considered necessary, Strömberg explained that the bank would rather have the borrower file for bankruptcy, as the court will then accept the application immediately.

Moreover, the bank can have the company apply for formal restructuring. While some of the interviewees criticise it for being "the worst restructuring legislation in Europe" (Legal advisor 1) and "completely toothless" (Investor 3), others, such as Bankruptcy trustee 1, believe the law is well written. Head of Risk 2 argues that it is most often used too late, when all other solutions have been tried, which implies that most restructurings fail. Nevertheless, the interviewees all agree that it is seldom used and, according to Head of Credits 2, banks instead try to restructure out-of-court.

Withdrawing the credit

When a firm is in financial distress the bank might prefer to withdraw the credit and ask for the full amount of the loan to be repaid, forcing the customer to find new ways to finance itself. However, all interviewees agree that it will be hard, if not impossible, for a company in financial distress to find a new bank. Head of Credit Committee 1 claims that there is "some kind of guideline stating that we should never take over another bank's bad credits". Head of Credits 1 believes that it originates from the banks' risk appetite: if they consider a company to be too risky, they know that other banks are likely to feel the same.

> “One of the great taboos in Swedish banking is, sort of unwritten between them, one Swedish bank will not take another one out of a bad loan. They simply do not do that” (Investor 1).

Something further complicating the situation is that there are few debt-investors in Sweden (other than banks) and the market for corporate bonds is underdeveloped (Strömberg). The banks are therefore aware of the fact that if the credit is withdrawn, the company is unlikely to find other funding and might be forced to file for bankruptcy. Although it was agreed that bankruptcy generally is avoided, the bank might punish the company by taking actions that lead to bankruptcy under certain circumstances:

> ”If we have an agreement stating that we are supposed to provide credits to a customer the next five years, then we cannot withdraw our credits. However, if they have misbehaved badly, we might do it anyway” (Loan Officer 2).

The bank employees were all aware of the fact that a bank’s reputation would have an impact on its future success. According to Investor 4, “reputation is very important for the banks to attract and retain customers”. Other interviewees also mention the negative attention from media as a reason for avoiding bankruptcy. Financial advisor 1 argues that due to the limited size of the Swedish market, larger bankruptcies are likely to be mentioned on the front pages of all Swedish business magazines. Usually the attention from media is not positive:

> “If we were to knock over a company with 200 employees in an industrial town, then we become the big bad bank and that’s something no one wants” (Head of Distressed Credits 4).

5.4.2 Retaining the relationship

Banks seldom terminate the relationships with their distressed customers. Instead, the interviewees explain that the banks initiates a number of work-out processes, both financial and operational, in order to improve the outlooks of the company. In addition, capital injections were also mentioned as an important part of the work-out.

Financial measures

According to Financial advisor 1, Swedish banks “often take a co-operative approach with their borrowers” when a customer is experiencing distress. Banks often try to reduce the distressed company’s financial burden in order to ameliorate its chances of surviving financial distress (Distressed Credit Manager 1). The interviewees mentioned that common responses to financial distress are to postpone the repayments or extend the maturity of the loan.

> “They [the banks] try with both removing the amortisations and the interest rate with the aim of saving their borrowers” (Legal Advisor 2).

In addition to altering the time to maturity of the debt, the interest on the loan is also often adjusted. Although it was recognised that a company in financial distress is of higher risk, and therefore should pay a higher interest rate, the bank employees agreed that increasing the interest rate is unlikely to save a company already experiencing liquidity shortages: “If an increase in the interest kills the company we are shooting ourselves in the foot” (Head of Distressed Credits 3). For that reason, the banks often lower the interest rate instead of increasing it: “You cannot pull the hair on someone who is bald” (Head of Credits 1). In some instances, banks go even further and remove the interest entirely (Financial Advisor 1, Head of Credits 1, Head of Distressed Credits 3 and Head of Distressed Credits 4).

Something that banks seldom do is to write down the face value of the loan: "it will be done as a last resort" (Financial Advisor 1). Also Head of Distressed Credits 2 and Financial Advisor 3 agreed that writing down the value of the loan, "taking a haircut", would be their very last choice.

> "Here is something that is unique to Sweden: the senior secured lenders in Sweden do not like the word haircut. They cannot stand the word haircut. But they are willing to give you almost everything in lure of that" Investor 1.

Another measure that the bank seldom takes is to extend credit to a distressed company (Head of Credits 1). Loan officer 2 argues that credit might be extended in some cases, but only to customers with whom the bank has a good relationship or to incentivise owners to invest additional equity:

> "Among the hardest thing to do is to lend more money to a company that is performing poorly. It is a very complicated decision. Throwing new money after bad credits" (Head of Credit Committee 1).

> "If the value of equity is gone and the owners are unwilling to invest additional capital, we might have to offer fresh credits in order for them to agree with our conditions" (Distressed Credit Manager 1).

Operational measures

Most interviewees highlight that it is often operational issues that are the underlying cause of distress. They note that, while financial measures might help in the beginning, most companies need to change their operations in order to survive distress. Head of Distressed Credits 2 explained that he always evaluates the distressed company operationally in order to understand what the problem is, and how to solve it. The interviewees mentioned that it is important to understand the current situation; for example demand, cost structure, and competitiveness.

When the issues have been identified, an action plan is commonly agreed upon and then frequently monitored by the bank (Head of Credit Committee 1). The bank might for example advise that the company lowers its cost base in general, cuts its dividend or disposes of some assets or an underperforming subsidiary (Head of Credits 1). Some interviewees claim that banks have much power and are able to decide about what operational changes should be made:

> "A lot, a lot. It can be really dangerous for the borrower if they violate the covenants" (Financial Advisor 1).

Others claim that the banks' restructuring teams rather act as consultants and that the operating decisions have to be made by the company's management:

> "We should never become a shadow director that directs the company. The board takes such decisions. We can give advice" (Head of Risk 2).

Nevertheless, they all agree that the bank does indeed have a lot of power; if the advice offered is not followed, the bank might threaten to terminate the credit:

> "We have the power to set quite demanding requirements. Actually. It depends on how good covenants we have but we can of course terminate the credit if we want to" (Head of Credit Committee 1).

When a company is in financial distress, most interviewees highlight the competence of management and owners as being important. For example, Head of Distressed Credits 2 explains that when dealing with companies in financial distress he practically always replaces the board of directors and all or parts of management. Several other interviewees also mention how they often request or suggest that the board of directors or the management team is replaced.

> ”We have lost our faith in this CEO who has spent so much money and made bad investments. It doesn’t fly” (Head of Risk 2).

> “It might be a good owner but a bad CEO” (Head of Credits 1).

> “Our key competence is credits, we are not concerned about how to run a company. We therefore let the management of the company do its job until we see that it is not working, then we might have to step in” (Risk Officer 1).

Capital injections

In distress, additional liquidity is often urgently needed:

> “it is almost always about cash flow [...] the company has burned through all of its money before seeking help and to get out of the hole you need money” (Financial Advisor 1).

While the owners would prefer the creditor to finance the shortage, banks are of the opposite opinion. Head of Credit Committee 1 and Head of Distressed Credits 4 both argue that it is the owner and not the bank that should invest more capital since the bank does not want to hold such risks. According to Head of Credits 1, additional capital investment is also a way for the owner to prove that he or she has serious intentions and believes in the business. He argues that in such a situation it will be easier for the bank to offer additional credit and share the risk with the owner. It is also a matter of risk:

> “There is almost never agreement of who carries the risk [...] the owner might argue that ‘you [the bank] are in the shit, it is your problem and therefore, you must pay in additional capital’ whereas the bank tell the owners: ‘there is actually a lot of equity left’ [...] Then there is a discussion of who carries the risk. The more risk you carry, the more capital you need to contribute with” (Legal Advisor 1).

In many cases the discussion ends up in a compromise whereby the owner invests more equity and the bank offers additional credit or writes off parts of the debt (Legal Advisor 2). If the owner is unwilling, or unable, to invest more money, the bank typically tries to look for a new owner, who can either be a co-investor or replace the previous owner entirely.

> “If you do not have any money you cannot keep anything. It is as easy as that” (Head of Risk 2).

> "And if the owner in question does not have any money, then there might be someone else that is willing to invest additional capital and outplay the current owner" (Legal Advisor 2).

Both Head of Distressed Credits 2 and Head of Credits 1 acknowledge that they, through their contacts, often are able to contact new owners that can invest more equity. Strömberg argues that private equity owned companies often are more likely to survive distress since the owners have easier access to capital than for example family-owned businesses.

Converting debt to equity

One option for the bank is to take over the ownership itself by converting debt into equity. In that case, the bank would let the company recover and sell it a few years later with the purpose of recovering the full value of the loan (Financial Advisor 3). This action is only taken if "there is no other option on the table and it is a business case that we believe in - that is the most important thing" (Head of Distressed Credits 4). However, it is rare that a bank takes over the ownership. As explained by Financial Advisor 1:

> "Banks are not in the business of owning companies; it does not suit their capital structure or their core business."

Head of Credit Committee 1 agrees and claims, "it is relatively seldom that we take over companies, we try to avoid it because a bank is not good at running industrial companies. So we do it extremely rarely." Nevertheless, Financial Advisor 2 acknowledges that:

> "[...] it is a real alternative and not an empty threat. The banks are well aware that this is an action that they can take and if they need to do it, they will."

6. Analysis

This section presents our analysis of the empirical data with the aim to answer our research questions. We start by investigating what factors affect the bank's decision to terminate the relationship or not when a borrower is experiencing financial distress. Based on previous research, we expect to find that the Five C's and the three added factors; relationship, regulatory setting and reputation will prove influential. We have found that, a ninth factor must be added in order to get a complete picture of the assessment: accounting standards. Our results indicate that Collateral and Capital are not critical in this decision. Additionally, low Capacity will not prove influential, as long as it is not caused by weak Conditions. Overall, banks are reluctant to terminate credits due to the existing relationship, reputational issues, bankruptcy legislation and accounting standards. Nevertheless, in case the outlook of Conditions are judged to be negative or if Character of the owners is low, banks are more likely to terminate the relationship.

When choosing to terminate the relationship, Swedish banks typically refrain from filing for bankruptcy on behalf of their borrower and also avoid selling their claims to a third party but instead, they withdraw the credits. This action is preferred as the accounting standards incentivise banks to keep the loan receivables on the balance sheet as long as possible and because there is no developed market for distressed debt in Sweden. Moving on, we find that banks use loosening financial actions, operational measures, capital injections and loan conversion in order to decrease the distress and minimise their credit losses. We also see that the action banks take is tightly connected to the value-break. As long as the value-break is high, they tend to use financial measures in order to ameliorate the short-term situation of the borrower. However, as the value deteriorates, banks tend to switch to more forceful actions.

6.1 Factors affecting the decision to terminate or retain the relationship

The bank has two options when it realises that a customer is undergoing financial distress: it can either terminate or retain the relationship. We have found that due to the existing relationship, the reputation, the accounting standards and the regulatory setting, banks normally only terminate their existing relationships as a last resort. However, banks are likely to terminate the relationship due to certain factors where character and condition are the important ones. In Figure 4 on the next page, we have summarised these factors and the effect they have on the decision that the bank take.

Factors affecting the decision to terminate or retain the relationship		
Factor	**Definition**	**Likely impact**
Character	The trustworthiness, integrity and commitment of owners and management	Banks may terminate the relationship if the owner of the company is deemed disloyal or if trust is broken
Condition	The economic conditions of the market and industry in which the company is operating	Banks are likely to terminate the relationship if the industry is deteriorating and not expected to improve. General business downturns have not been found to have the same effect
Capacity	The company's ability to repay its debt by generating cash flows	If capacity is low due to operational weaknesses, the relationship is not likely to be terminated. However, if capacity is low due to weak conditions that are not expected to improve, the relationship might indeed be terminated
Collateral	The amount of collateral that is protecting the bank's claim	Found to have little impact on the decision to terminate or retain the relationship
Capital	The equity investments made by the owners	Found to have little impact on the decision to terminate or retain the relationship
Existing relationship	The bank's relationship with the company	Close relationships that have lasted for a long time make the banks more inclined to continue supporting the borrowing firm
Reputation	The reputation of the bank	Banks are often reluctant to terminate the relationship to keep their reputation intact
Accounting standards	The way that prevailing accounting standards, IFRS, are used by the banks	The way of accounting for loan receivables increases the banks' incentive to keep the customer
Bankruptcy legislation	Swedish Bankruptcy law and how it is used in practice	Banks are hesitant towards terminating the relationship as it might force the borrowers into bankruptcy; something that is generally seen as a failure

Figure 4. The figure summarises the factors' affect on banks decision to withdraw credits or not. It first describes the 5Cs and continues with additional factors.

Character

Several of the interviewees mentioned that it is important that the management of distressed companies is competent and trustworthy - their Character has to be perceived as good. However, we have also noted that the competence of management seldom was a strong factor in the decision to support or not support the relationship. The reason, according to the interviewees, was that the banks would be able to replace incompetent managers.

The Character of the owners was perceived to be all the more important. The Swedish banks have close relationships with their lenders and they all highlight that such a relationship should be built on mutual trust and commitment. As found by Boot (2000), trust is a key component of relationship banking. If the lender violates this relationship, bank's willingness to sustain it will decrease substantially. In fact, if the customer has acted in bad faith or has withheld important information, the bank might even terminate the credits immediately, even though it might lead to substantially higher credit losses: "this person has acted in a way that is not in accordance with what we expected [...] and in some cases, we are willing to make extra credit losses to get out of the relationship" (Head of Credits 2). The betrayal is considered a breach of trust that the bank cannot tolerate. While Baiden (2011) and Danos et al. (1989) find that the Character of the owners is of high importance in the initial decision to lend money, we find that the same appear to hold also in the decision to end the relationship or not.

Condition

External factors such as macroeconomic downturns and industry trends will often be a reason for companies being in financial distress. The bank therefore has to evaluate whether the downturn is temporary or expected to remain. The interviewees mentioned that a decline in performance resulting from a temporary industry downturn will not provide enough reason to terminate the relationship with a borrower. However, the bank employees all agreed that they would aim to terminate the relationship with companies in perishing industries since the Conditions were not expected to ever improve.

As highlighted by D'Aveni (1989), it is hard to know what industries will be successful in the future. While some industries, such as typewriters or mechanical calculators, were mentioned as clearly not worth supporting, the interviewees highlighted that it in most cases is hard to predict the future of a company. As argued by Head of Credits 1 "no one can know the future for certain". In this process banks might be influenced by the borrower's projections and let them continue the business: "[...] who am I to say no if they want to try?" (Head of Distressed Credits 5). Boot (2000) argues that granting seniority to the bank would ameliorate such a soft-budget constraint, but we find no evidence of this.

Capacity

Capacity will seldom be positive for a company in financial distress as financial distress is defined by deteriorated financials. Thus, this factor will, in most cases, not be favourable for the borrowing company. Therefore, the bank has to understand the causes of the low capacity in order to judge how to act. Capacity is often closely related to low Conditions, whereby these Conditions have to be analysed in order to find out if the Capacity can be expected to improve. If Capacity is judged to be low due to the company operating in a perishing industry, the bank is likely to terminate the relationship.

However, Capacity can be low although Conditions are good. In such a situation, it is often operational weaknesses, such as a too high cost base, that has caused the low Capacity. Such issues can be addressed by the bank in order to mitigate the distress. Hence, low Capacity due to operating weaknesses will typically not be a strong enough reason for the bank to terminate the relationship. In contrast to initial credit granting, Capacity is not judged to be as important when companies are in distress, as Berry and Robertsson (2006), Kwok (2002) and Danos et al (1989) have found it to be in initial credit decisions.

Collateral

Swedish banks often use collateral in their loan contracts in order to limit their downside risk. Similar to Frank and Sussman (2005), we find that banks do rely on collateral but there is no evidence that the bank would be more prone to end the relationship if it is secured by collateral. Only Strömberg mentioned that this would even be an option. Head of Distressed Credits 4, Bankruptcy trustee 1 and Legal advisor 1 all argued that this was never done in practice. These results indicate that collateral does not have a significant impact on the bank's decision to end or retain the relationship. Our findings neither support that banks terminate the credits if the value of the collateral is high (as found by for example Gilson, 1990 and Bulow and Showen, 1978), nor that collateral increases the chances of the banks supporting distressed companies (as found by Elsas and Krahnen, 2000 and Fischer and Martel, 1995)

Capital

The equity stake in the company and the owner's ability to invest additional equity has not been found to be a decisive factor for continuing the relationship or not. Rather, it may have an impact on how the owner is treated by the bank and to what extent he or she can remain as owner. From the interviews, it was clear that if the current owner cannot provide additional equity, the bank would be able to take actions to mitigate this problem.

Relationship

Swedish banks are relationship lenders and having close relationships with their customers is an important aspect of their business model. The interviewees from the banks referred to themselves as "no ordinary supplier" (Head of Credit Committee 1); claiming that the relationship with their borrowers "is like a marriage" that should last "as long as possible" (Head of distressed credits 3). Since borrowers are seen as lifetime customers, Swedish banks can take a long-term perspective and look beyond optimising short-term earnings and will therefore avoid ending the relationship. This is in line with Peterson and Rajan (1995), who find that relationship banks can endure short-term losses in order to get long-run profits.

Given the importance of strong relationships the banks want to be perceived as good business partners that do not terminate the relationship prematurely. Such an action would be seen as "a betrayal of the customer" (Head of Risk 2). Thus, the banks are inclined to continue supporting the relationship as, they "want to stay true to their promises" (Swedbank AR, 2012 p. 7). Our findings support Boot (2000), as we see that the relationship will increase the banks' willingness to continue supporting customers facing financial distress.

Previous researchers (for example Boot, 2000) discuss the hold-out problem as a potential issue for borrowers engaged in relationship banking; arguing that it is difficult for them to pull out of the relationship if they have a close relation to the bank. However, we find that this problem also tends to apply to the lender: given the strong relationships the bank is unlikely to terminate the credit, and is instead stuck with the distressed customer.

Reputation

Swedish banks are concerned about their reputation since it affects their ability to attract and retain customers. If the bank would terminate the relationship with an existing customer, the company would most likely have to file for bankruptcy and "the bank would be seen as 'the big bad bank'" (Head of Distressed Credits 4). Negative attention from media was therefore a reason for avoiding termination of the relationship with distressed companies that was mentioned by several of the interviewees. As found by Moussu et al. (2013), a poor reputation might obstruct in developing the relationships that the business model is built upon, which in turn could reduce future revenues. The same is supported by Investor 3: "reputation is very important for the bank to attract and retain customers."

Accounting standards

The way that the banks use prevailing Swedish accounting standards results in them not writing down the loan receivable of a distressed customer, although the loan might be impaired. Instead, banks have an incentive to keep the loan receivables in their books as long as possible in order to avoid credit losses. Head of Distressed Credits 5 illustrated this by saying: "we had no idea if we would get our money back but the loan was never impaired in the books". Thus, the loan receivables are usually kept unimpaired until the borrower files for bankruptcy. However, if the bank were to dispose of the holding in some way, for example by selling the debt, it would have to recognise the credit losses immediately. As argued by Strömberg, accounting standards might therefore be a contributing factor to why banks do not want to end the relationship with their customers.

Bankruptcy legislation

As found by Couwenberg and De Jong (2006), local bankruptcy legislation will have a large impact on the resolution of financial distress, which also appears to be the case in Sweden. If the bank decides to terminate the relationship with a customer, it is likely that it will have to file for bankruptcy. Throughout the interviews, it has become clear that bankruptcies in Sweden are highly associated with failure. The interviewees claimed that bankruptcies were commonly seen as "Game over" (Head of Distressed Credits 4) and "Really scary" (Head of Risk 2). Indeed, in a bankruptcy "[…] you kill a legal entity and that cannot be undone" (Head of Credits 2). As bankruptcies normally are avoided, the banks also refrain from actions, such as terminating the relationship, which might result in the company filing for bankruptcy.

The interviewees argue that bankruptcies are more closely related to failure than in other countries. One reason might be that it is mainly bankruptcies, and not formal restructurings, that are used in Sweden. This is in contrast to the US, where Chapter 11 is used; a process where the company most often continues as a going concern and the relationship with the bank remains. While formal restructurings also are possible in Sweden, the interviewees agree that similar processes seldom are used.

Conclusion - factors affecting the decision to terminate or retain the relationship

In summary, we have noted that Swedish banks are unwilling to terminate the relationships with their customers. This reluctance is primarily attributable to the current relationship with the customers, the regulatory setting, accounting standards and the reputation. In addition, the banks normally abstain from terminating the relationship due to purely financial reasons, as they would, most likely, be forced to recognise large credit losses. We have also found that banks are likely to terminate the relationship with a distressed company if Conditions are considered bad and not likely to improve. It is also likely to be terminated if the Character of owners is considered weak; if they have acted dishonestly and damaged the relationship.

6.2 Actions taken by the bank when a borrower is in financial distress

When a borrowing firm is in financial distress, the bank has two choices: it can either choose to end the relationship or retain it. While we have found that banks in most cases choose to retain the relationship, we will analyse the different actions taken by the banks depending on the choice made.

6.2.1 Terminating the relationship

We have seen that banks have three alternatives if they want to terminate the relationship with a customer: they can sell their debt positions, file for bankruptcy on behalf of the borrower or withdraw the credit. All these actions are tightening measures that banks only use when conditions are deemed bad or the trust is broken. We have found that banks mainly use the last one, terminating the credit, due to accounting standards and the regulatory setting. These findings are summarised in Figure 5 below.

Actions taken if terminating the relationship		
Type of measure	**Action**	**When and why it is expected to be used**
	Tightening	
Financial	Selling the debt	Seldom used, owing to the way that accounting standards are used; leaving little incentive for the banks to sell their debt positions
	Filing for bankruptcy	Rarely used due to the way that the bankruptcy law is written; making it more efficient for the company to file for bankruptcy itself
	Withdrawing the credit	Most common way for the banks to terminate the relationship. Likely to be used if conditions are bad or character is low. Might also be used as a final choice when the work-out is considered to have failed, in c)

Figure 5. Summary of the actions that a bank can take to get out of the relationship.

Selling the debt

One way for the bank to get out of the relationship with a distressed customer would be to sell the debt to another bank or an investor. In doing so, the bank could also avoid forcing the company into bankruptcy. However, selling their debt positions is something that banks rarely do. Some individuals such as Head of Risk 2 and Investor 2 maintained that this was due to the relationship with the company; arguing that selling the debt would be disloyal to the customer. Another explanation to why Swedish banks do not sell their debt is offered by Strömberg:

> "You do not want to do it [sell the claim] because it forces you to realise a credit loss. There is no research proving this but you hear people in the market saying that it is hard to make banks dispose of their loans due to this" (Strömberg).

The way that Swedish accounting standards are written makes the banks reluctant to sell their assets, since it would force them to recognise credit losses. The Swedish banks' behaviour is in contrast to American banks'. In the US, the loans are booked at fair value, which implies that they are impaired at a much earlier stage. As a consequence, US banks are more willing to sell their underperforming loans compared to their Swedish peers, since they have already accounted for the losses (Investor 1). Accounting standards will thus have an impact on the bank's actions of customers in distress. Hold-to-maturity accounting is likely to make Swedish banks retain their customers for a longer period of time compared to the American counterparts. Instead of selling the loans and taking an immediate loss, the banks keep the loans unimpaired and hope for recovery. If the companies do not recover, the banks might terminate the relationship by withdrawing the credits at a later stage where few investors would be willing to take over the severely distressed company.

Filing for bankruptcy

It is unusual that the bank files for bankruptcy on behalf of the distressed company. One reason why this is seldom done is due to the way the Swedish law is written: if the company itself files for bankruptcy, the filing will be approved immediately, whereas if the bank does it, it will take longer time. Therefore, if the bank wants to terminate the relationship, it will likely do so by withdrawing the credit instead of filing for bankruptcy on behalf of the customer.

Withdrawing the credit

Since selling the debt seldom is an option and the bank does not want to file for bankruptcy on behalf of the customer, termination of credit is the main way for the bank the end the relationship with a borrower - leaving the company to find other means of financing. Due to the lack of alternative funding, credits are seldom withdrawn, as it is likely to force the borrower to file for bankruptcy. This behaviour does not seem to be specific to our setting; Brown et al. (1993), Couwenberg and De Jong (2006) and Nini et al. (2009) also argue that withdrawn credits are likely to lead to the company filing for bankruptcy. Terminating the credit is therefore seen as a "last way out that will be avoided as long as possible" (Head of Distressed Credits 2). However, banks may do it if the conditions are judged to be bad or if the trust has been broken.

Moreover, the banks in our study refrain from taking actions that might lead to bankruptcy given that the full face value of the loan seldom is recovered in such a situation. Thorburn (2000) found that, in addition to wiping out all of the equity, approximately 30% of the banks' claims are lost in liquidation. The interviewees also acknowledge that the common conception of bankruptcies in Sweden is negative - it is perceived as "Game over" (Head of Distressed Credits 4). Formal restructurings are also rarely used in Sweden, as recognized by Hotchkiss et al. (2008). Similarly to Couwenberg and De Jong (2006), we find that banks most often do not use in-court restructurings, as was claimed by most of the interviewees. Just as Brown et al. (1993) we find that, under most circumstances, banks avoid taking actions that will force the borrower to file for bankruptcy.

Contrary to our findings, Strömberg and Thorburn (1996) found that the banks in their study indeed terminated their credits rather often. However, their study only focused on companies that later filed for bankruptcy. Since withdrawing the credit increases the risk of bankruptcy, it is possible that the study by Strömberg and Thorburn was biased towards borrowers that the banks did not want to keep.

Conclusion - Actions taken when terminating the relationship

We have found that banks, to a large extent, only use termination of outstanding credits as a way of ending the relationship with a distressed borrower. This is primarily due to two factors. Firstly, the accounting standards provide incentives for the bank to keep the assets on the balance sheet for as long as possible. Secondly, due to regulatory issues, the bank will not file for bankruptcy on behalf of the borrower. In addition, just as Brown et al. (1993), we find that banks normally avoid taking actions that might lead to the company filing for bankruptcy as it is costly, damages their reputation and is disrespectful to the borrower.

6.2.2 Retaining the relationship

The alternative to terminating the relationship with a borrower undergoing financial distress would be to retain the relationship. We have found that the bank focuses on financial and operational measures as well as capital injections and converting debt to equity. While financial measures are used mainly in the earlier stages of distress, operational measures are more common in the later stages. Capital injections are necessary throughout all stages of financial distress whereas loan conversion is only used as a last resort. We have also found that it is important to understand how the economic ownership of the company shifts from equity holders to debt holders as the company's distress worsens. The actions that the bank takes are summarised in Figure 6 on the next page should be read together with Figure 7 depicting the value-break.

Actions taken if retaining the relationship

Type of measure	Action	When and why it is expected to be used
No action	Waiting	Banks are often hesitant to act when collateral is perceived to protect it from potential losses or when the severity of the situation is not yet understood
Financial	Tightening	Tightening actions are seldom used when the banks want to retain the relationship
	Loosening	
	Lower interest rate	Primarily used in the beginning of the work-out process, around a), to relieve the borrower of some of its financial burden
	Remove interest rate	Often used when lowered interest rates are not found to be enough to reduce the level of distress, around b)
	Postpone amortisations	Often used in relation to removed interest rates
	Additional credit	Additional credits are rarely offered by the banks. Might be used in cases of severe distress, in c), to incentivise equity holders to invest more capital
	Forgive principal	Just as with additional credits, banks seldom forgive principal but might do so to incentivise equity holders
Operational	A number of actions might be taken, such as: Reduce cost base, Sell off assets, Replace executives	Often used throughout the work-out process. The actions taken will depend on the specific needs of the borrower. The more distressed the company and the lower the value-break, the more forcefully the bank can be expected to engage in the operations
Capital injections	Request additional equity	Banks often try to have the owners invest additional equity in the company throughout the process. However, the lower the value-break, the more concessions are often needed to be made by the bank, such as offering additional credit, in order to incentivise equity holders
	Change owners	If current owners are unable or unwilling to invest more equity
Converting debt to equity	The bank becomes the owner of the company by converting the debt into equity	Most often seen as a last resort when all other activities have failed. Might then be used at c) in order to avoid credit losses

Figure 6. The figure summarises the actions that Swedish banks take when their customers undergo financial distress. The actions are divided into four categories and when each action is used is linked to the value-break framework presented in section 3. Theoretical Framework.

When and what actions that are taken by the bank will depend on what risks it is carrying. The risks are reflected in the "value-break", which portrays the current enterprise value (the present value of future forecasted free cash flows) and which investor is impaired. We have developed a simple illustration of the value-break (Figure 7 below) that is described more in detail in section 3.2 Value-break.

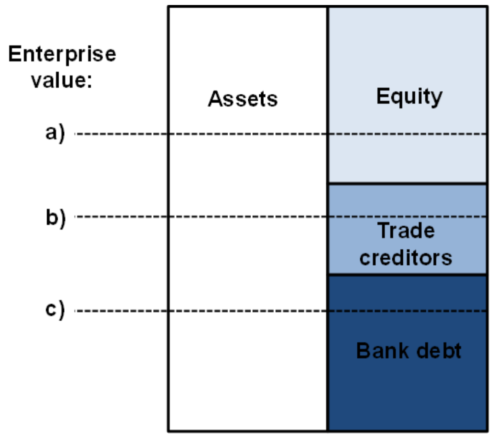

Figure 7. Schematic illustration of the value-break - depicting the value of the company and what claimants are impaired.

No action

Contrary to Nini et al. (2009), who find that banks take action quickly following a breach of covenants, both bank employees and advisors in our study claim that covenants often are breached a couple of times before the bank takes action. One reason why a bank might wait to act is because the value-break still is at a) or because it believes that it is protected by collateral. Couwenberg and De Jong (2006) argue that such a behaviour leads to the banks doing too little too late, which also seems to be the case in Sweden.

Another reason the bank's actions are delayed is because of the existing relationship with the customer. While Strömberg and Thorburn (1996) argue that close relationships will be beneficial for the banks since it allows them to quickly respond to customers in financial distress, we find that the existing relationships also act in the opposite way. As argued by Bankruptcy Trustee 1: "It is the same as with many long relations; you become passive since it has worked out well the last 20 years. And you've had similar ups and downs before so it probably will not get any worse this time". The bank therefore expects the borrower to cope with the situation as it has previously done and does not realise the severity of the situation.

As a consequence of the bank not taking action early, the company's distress often deteriorates even further before the bank finally takes action. While the bank might have had the chance to act at point a) in the value-break, where only equity is impaired and less vigorous actions would be necessary to get the company back on track, they often take action when the value breaks at b) where the bank debt is close to being impaired. In such a situation the bank must act forcefully in order to help the company and avoid making any credit losses.

Financial measures

When trying to save a distressed company, the interviewees claimed that financial measures were used first, when the value-break was still perceived to be high. Such measures can be either loosening or tightening in their nature, as defined by Asquith et al. (1994). While Franks and Sussman (2005), studying British banks' behaviours during the end of the nineties, found tightening measures to be most common, the Swedish banks in our study behave in the opposite way. The interviewees described that loosening measures such as reduced interest payments and amortisations were most commonly used. Asquith et al. (1994) explain that loosening measures will be used more often if the bank is protected by collateral or the company is considered a viable firm.

While the viability of the company's market and good Conditions was a prerequisite for the bank to not end the relationship, collateral does not seem to have the same impact in Sweden as described by the authors. Collateral rather appeared to have an effect on *when* the banks decide to act, not *how* they do it. This can be related to the value-break: as long as the banks are protected by collateral, they do not have to take any actions at all. If, however, the value of the collateral is low, the banks know that a lot of value would be lost in a potential bankruptcy. As a consequence, they have to act forcefully in order to not make credit losses.

In the early stages of financial distress, at point a) in the value-break, Swedish banks tend to adjust the interest rate. Contrary to what is prescribed by corporate finance theory (see for example Berk and DeMarzo, 2013) where a company more risky operations should be charged a higher interest rate, Franks and Sussman (2005) saw that banks seldom increased the interest rate spread once firms were in financial distress. The authors argue that this was because the banks wanted to ease the financial burden of the companies and get them out their distressed state. The interviewees in our study explained that the banks not only refrain from increasing the interest rate but rather decrease it, or even remove it completely. This is also one measure that Strömberg and Thorburn (1996) identified in their study. The lower the value-break and the more distressed the company is, the less it can expect to have to pay in interest to the bank.

If the company's distress deteriorates further, to b) in the value-break, the interviewees explained that amortisations normally are postponed; resulting in the company being relieved of all payments to the bank. The banks' willingness to remove both interest rates and amortisations is, according to the interviewees, a way for the banks to reduce at least some of the distressed company's financial strain. This behaviour might imply that Swedish banks go even further than described by Franks and Sussman (2005) in their quest to help the companies recover and avoid credit losses.

One loosening measure that the banks almost never take is to grant additional credit. This hesitation towards offering additional credit is in contrast to the findings of Jostarndt and Sautner (2010), who saw that German banks often offer fresh credit to troubled firms. While additional credit would imply valuable cash injections to a company suffering from liquidity shortages, the interviewees explain that they refrain from doing this because of the banks' risk appetite. They argue that it is rather equity, and not debt, that should be invested. If the bank was to offer additional credit and the value-break was at a), it would result in a wealth-transfer to equity holders. Additional credits will therefore only be granted if the value breaks at c), when that the bank debt is impaired, in order to stave off credit losses. These findings are in line with Peek and Rosengren (2005), who saw that Japanese banks only extend credits to the most distressed customers as a way of avoiding credit losses. If Swedish banks are to offer additional credits, the interviewees highlighted that equity holders also must invest additional capital, in order to share the risk and financial burden. However, Loan Officer 2 added that in some rare cases, additional credit might be granted to loyal customers in order to cover liquidity shortages.

Just as additional credit seldom is granted, banks rarely forgive even parts of the principal. As argued by Investor 1: "the senior secured lenders in Sweden [...] cannot stand the word haircut". This behaviour is in line with the findings of Franks and Sussman (2005) and Asquith et al. (1994) but contrary to Jostarndt and Sautner (2010), who find that it often occurs in Germany. The bank employees in our study questioned how debt forgiveness would be beneficial for a distressed company. Since liquidity shortages are the most common reason for being in distress, they argued that writing down the principal would not solve the problem. This is also supported by Asquith et al. (1994) who highlight that the banks have other more efficient measures they can use, such as lowering the interest rate, that do not reduce the bank's own claims. The only time forgiveness of parts of the debt would occur would be when the company is severely distressed, at c), as concession to incentivise the owners to invest additional equity. However, since the banks will recognise an immediate loss when forgiving parts of the debt, they would rather extend the credit and postpone potential losses to the future.

Operational measures

Operational measures are often used later in the work-out process, at b), when the bank has unsuccessfully tried to take certain financial measures. The importance of operational measures was highlighted by Head of Distressed Credits 2, who argued that it is important to address the underlying reasons for the company being in its distressed state.

The article by Couwenberg and De Jong (2006) is one of few studies highlighting that the banks engage in the companies' operations; finding that the involvement of the bank increases the likelihood of the company surviving financial distress. We have seen that the Swedish banks in our study are involved in the work-out processes. The interviewees mentioned that the bank might, for example, make the company reduce its cost base or sell off certain assets. If Capacity is low due to operational weaknesses, the bank will therefore address these issues with the aim to mitigating the distress. We have also found that banks are able to replace top management if they are considered unable to turn the business around, which has also been found in previous research (see for example Ozelge and Saunders, 2009 and Nini et al. 2012). Additionally, just as Nini et al. (2012), we hence find that creditors offer an important role in corporate governance.

Moreover, the interviewees do not unanimously answer the question of what decision making power the bank has. Some claimed that the bank can only make suggestions for improvements, while others argue that the threat of withdrawn credits is sufficient to demand real changes. However, the decision making power will depend on where the value breaks. Since banks' key competence lies within finance, they will refrain from taking charge of operations for as long as possible (Financial advisor 3).

As the value of the company decreases, the more economic ownership is transferred from equity holders to debt holders. At a point where the bank is the only remaining claimant, at c), it has the full economic ownership of the company and can make operational decisions, even though equity owners still hold the legal title to the company. Since equity is wiped out and the owners have nothing more to lose, the equity investors have an incentive to take on excessive risk in order to increase the chances of regaining their value. In such a situation, banks will make sure to be involved in the operations to minimise the owners' risk-seeking behaviour.

Capital injections

Since distressed companies often are cash constrained, external capital injections are important. As stressed by bankruptcy trustee 2: "[cash] is for companies what blood is for humans". Equity investments by the owners or credit extensions by the bank are therefore important.

While Baiden (2011) argues that a strong equity position ensures that the owners remain committed to the business, he does not explore how their commitment changes when that position is impaired. The interviewees in our study, especially the bank employees, argue that since equity is what is first impaired when a company is distressed, owners are the ones that should invest more money.

At a), the banks can justifiably demand that the owners invest more equity, since they are the only ones that are impaired. When the value-break decreases, the owners' incentive to invest more equity will shift. When equity is wiped out, at b) or c), they have little incentive to invest additional capital since it is likely to result in a wealth-transfer to other more senior claimants. In such a situation, owners will only invest more money if the banks also make concessions, such as writing down parts of the debt or offering more credit.

The extent to which banks can demand equity investments from the owner will also depend on the owners' access to capital. In a situation where the owner is unwilling, or unable, to make additional investments, the bank will try to find a new owner who can make the necessary investments. Contrary to Couwenberg and De Jong (2006), we therefore find that the owners' ability to invest additional equity will have an impact on the resolution of financial distress - especially the extent to which the owner is able to remain involved in the company.

Converting debt to equity

The interviewees acknowledge that in case no new owner can be found, the bank itself will take over the ownership. This is the last action that the bank will consider taking, if they do not want to withdraw the credits and have the company file for bankruptcy. At this stage the company is severely distressed and the value-break is at c) or even lower. By converting the loan to equity, the bank aims to sell the company after a few years, once the value has increased, in order to avoid recognising credit losses. Essential in this case, which is also noted by James (1995), is that the company is considered viable with good growth prospects. In other words, future Conditions have to be considered good.

While Gilson (1990) finds that it is uncommon that European banks take equity, we find that, although rare, it does indeed occur. Our findings are also in contrast to Franks and Sanzhar (2004) who argue that banks will avoid equity holdings in unlisted companies. However, the authors and also Gilson (1990), mainly refer to situations where banks accept minority positions in exchange for debt write-downs. Contrary, Swedish banks aim for majority positions and almost never write down the debt.

Conclusion - Actions taken by the bank when retaining the relationship

We have found that banks initially tend to take a passive approach, as they often perceive their position in the value-break to be higher than it actually is or are because they are protected by collateral. Secondly, the banks use financial measures, operational measures, capital injections and loan conversions to try to minimise their credit losses. Although it takes time for banks to act, our findings support Nini et al. (2012): banks start taking action before their claim is impaired, but not as early as one could expect from the argumentation of Strömberg and Thorburn (1996).

7. Discussion

We set out to investigate how banks treat Swedish medium sized companies when they are undergoing financial distress. Our study, being qualitative in nature, is based on interviews with a total of 27 individuals; representing all four major Swedish banks, one minor bank, financial advisors, legal advisors, bankruptcy trustees, company owners and Professor Per Strömberg. Initially, we have aimed to answer the question "what factors affect the banks' decision to terminate or retain the relationship with a company that undergoes financial distress?". This question is analysed with the support of the Five C's of credit, a framework described by Beaulieu (1994), which defines factors that are important in initial credit decisions. We add four factors to the framework in order to adapt it to credit decisions in a distressed setting: Relationship, Accounting standards, Bankruptcy legislation and Reputation. Following, we aim to answer our last question, which is two-fold: "What actions are taken if: a) the bank decides to end the relationship and why are they taken? and if b) the bank decides to retain the relationship and why are they taken?". In the following sections we answer our questions and discuss our findings.

7.1 Main findings

Primarily, we have aimed to investigate what factors affect the banks' decision to terminate or retain the relationship when a borrowing firm is undergoing financial distress. We have found that banks are generally reluctant to terminate the relationship due to a number of reasons. Since relationship banking is prevailing in Sweden, banks aim for long relationships with their borrowers. Terminating the relationship would therefore often be seen as a betrayal of the customer. The banks' reputation, which affects their ability to attract future customers, would also be damaged if relationships were frequently terminated. In addition, the bankruptcy legislation - being biased towards liquidation - reduces the banks' willingness to terminate the relationship with a distressed borrower. This is also the effect of the accounting standards; the way that they are currently used give banks little incentive to sell their claims. Besides, the banks know that if the relationship is terminated, the borrower is likely to be forced to file for bankruptcy given that few other sources of funding exist.

Moreover, we have found that banks are likely to terminate the relationship on two occasions. To begin with, it might be terminated if the market for the company's products is not considered viable and not expected to improve. Secondly, the relationship is likely to be terminated if the bank feels that the owners have acted dishonestly and violated the trust that the relationship is supposed to be built on.

Our second research question concerns the actions taken by the bank if it chooses to either end or retain the relationship with a distressed company. We have seen that when the bank decides to terminate the relationship, the action taken is fairly straightforward: it withdraws the credits and demands that the firm repays its outstanding loans. The bank can also terminate the relationship by filing for bankruptcy on behalf of the company, although this is seldom done due to the Swedish bankruptcy legislation. Another option for the bank would be to sell its debt at an early stage of the financial distress. However, this would force them to realise an immediate credit loss, given the prevailing accounting standards in Sweden. Instead of selling the debt the banks therefore keep the loan unimpaired in their books and hope for recovery.

If the bank does not terminate the relationship, we have found that it most often strives to reduce the borrower's financial distress in order to avoid bankruptcy and credit losses. In order to do so, it is likely to use a number of financial and operational measures. To begin with, the bank often reduces or even removes the interest payments entirely - an action also found by Franks and Sussman (2005) to be frequently used. Following, the bank frequently aids the company in altering its operations in order to address the causes of the financial distress. Capital injections are also found to be important to reduce the distress. The more distressed the company is, the more concessions the bank is likely to make, in order to incentivise owners to invest more capital. The bank might for example have to offer additional credit or write down parts of the debt. Also, the bank can consider replacing cash-constrained owners with new equity investors or, in severely distressed cases, taking over the company entirely by converting the debt into equity.

Moreover, we have used the value-break in order to understand why certain actions are taken. The value-break depicts the value of the distressed company and which investors' claims are impaired. Initially, the bank has few incentives to act forcefully or make any concessions, as only equity is impaired. However, we have seen that the further the value deteriorates, the more forcefully the bank has to act, in order to decrease the level of distress. As the bank debt becomes close to impairment, the bank therefore takes vigorous actions to avoid credit losses. At a severely distressed stage, the bank oftentimes aims to be deeply involved in the operations of the company. This is because the equity holders, whose claims are eradicated, have an incentive to engage in risk-seeking behaviour that does not correspond to the banks' risk aversion.

All in all, the way the Swedish banks act is closely related to their business model. To being with, relationship banking implies that the banks value the relationship and want to finance the borrower going forward. Furthermore, given the thin margins of their business, large credit losses will significantly affect their profits. We have seen that banks try to keep credit losses low by assuring that the distressed borrowers do not go bankrupt. Banks therefore do not try to save the distressed companies only because they feel sorry for the employees that would risk losing their jobs and the owners that would lose their invested capital. Rather, the actions are taken in a profit-maximising organisation where the avoidance of costly credit losses is a part of the business.

7.2 Contribution

Previous researchers identify certain factors that might be of importance for banks in initial credit decisions. However, there is little guidance on how the importance of these factors will alter when an existing borrower undergoes financial distress. Moreover, the studies that investigate actions that banks take when companies are in financial distress mainly focus on large, publicly listed firms in other countries than Sweden. In addition, the research is almost exclusively quantitative, which limits the ability to gain a deeper understanding about why the banks act in certain ways.

One contribution of our study is therefore that it provides empirical description of the underlying reasons for banks' decisions, something that is not extensively covered in today's relationship banking literature. Our study goes further than previous research in three aspects:

1. it offers a comprehensive mapping of factors that influence the bank's decision to either terminate or retain the relationship with a distressed borrower when relationship banking prevails
2. it discusses under what conditions certain actions are taken by the bank and it also ties the actions to the borrower's level of distress as well as the bank's incentives

3. it provides an insight to the role of the creditors when companies undergo financial distress

7.3 Possible implications

Throughout our study, we have noted that the banks invest both time and resources to get their borrowers out of financial distress. Indeed, several of the distressed credit managers highlighted that there have been few medium sized companies going bankrupt in Sweden following the financial crisis of 2009. While this might be a proof of the banks succeeding in their rescue operations, Legal Advisor 2 noticed that some of the impact probably is due to the low interest rates that have been prevailing during the last years. Although we do not aim to evaluate the effectiveness of the banks actions, it is worth mentioning that there might be other ways to deal with distressed companies. An alternative would for example be for the banks to sell their underperforming loans and instead focus on their core capabilities. Nevertheless, such a situation would require a change in how underperforming loans are accounted for in order to alter the banks' incentives. Another alternative would be for the banks to take action at an earlier stage of the financial distress.

Our findings might also have implications for the management and owners of Swedish companies. We have found that Swedish banks, in line with what has been suggested by Nini et al. (2009), do play an important corporate governance role when borrowers are in financial distress. In the Swedish case, the banks' role in corporate governance seems to be even stronger than what was found by Nini et al. One potential reason might be the Swedish companies' high dependency on one bank and the banks' corresponding exposure to borrowers filing for bankruptcy.

In addition to having an impact on the banks as well as the management and owners of distressed companies, the findings of our thesis might also have implications for society at large. While the banks seem to be able to save many companies, it is questionable to what extent all companies should be allowed to survive. As argued by White (1984), there are indeed inefficient firms that should be allowed to fail so that other entrepreneurs can use the capital more efficiently. If Swedish banks are biased towards allowing inefficient firms to survive, it might lead to adverse effects. It may result in the creation of "Zombie companies" - inefficient firms that can service but not repay their debt (Financial Times, 2013) - that are allowed to continue operating as banks are unwilling to recognise losses.

Moreover, the future implications of our findings are also interesting to discuss. While relationship banking has prevailed in Sweden for a long time, it is uncertain to what extent it can continue in the future. The banks' behaviour might change due to three reasons. To begin with, new capital requirements for the banks, such as Basel III, can reduce the banks' incentives to retain the relationships with distressed customers, as it will be more costly to do so. Several interviewees also forecast that foreign banks, with less focus on relationship banking, are about to enter the Swedish market and compete based on price rather than relationship. In such a setting, banks are more likely to pull out of a relationship with a distressed customer. Finally, more Swedish companies are likely to choose to be financed by public debt in the future (Gunnarsdottir and Lindh, 2011). Similar creditors have been found to show less support for distressed companies (Bulow and Showen, 1978). The effect of these three factors is still to be seen but a harsher climate for distressed borrowers can probably be expected in the future.

7.4 Generalisability

In the following section we discuss the applicability of our results to a wider context. Firstly, we consider to what extent the findings can be generalised to Swedish companies of different sizes. According to the loan officers in our study, banks handle the lending to smaller companies (sales < 20 MEUR) as a portfolio of assets, rather than case by case. Thus, the relationship will not be as important as when considering larger companies. Consequently, banks are not expected to have equally large incentives to help the borrowers out of financial distress. In addition, the amount that is lent to these companies is rather small and will thus only incur minor credit losses for the bank. However, in the case of larger companies (sales > 50 MEUR), the effect is expected to be the opposite. If a similar company was to file for bankruptcy, the effects would be severe and the bank's credit losses would be large - suggesting that the bank will do its best to save the company. Another factor further complicating the situation is that larger companies often are publicly listed and have several banks participating in the financing, which might lead to negotiation difficulties in times of financial distress.

Secondly, we consider the generalisability of our findings to other countries. We have developed a framework of factors that affect Swedish banks' decisions to terminate or retain the relationship, which can serve as guidance for understanding banks' behaviour also in other countries. However, in different settings, the factors must be adopted to the specific circumstances in the country at hand. For example, the institutional factors Bankruptcy legislation and Accounting standards are expected to have an impact on what incentives banks have to behave in certain ways. A regulatory system biased towards liquidation, such as the Swedish and Dutch ones, are likely to incentivise both owners and banks to restructure out-of-court. However, one of the most important factors to consider is the existing relationship between the borrower and the bank. In countries where relationship banking is dominant, such as Germany or Japan, banks can be expected to be more keen to save the borrower compared to more transaction-based banking systems like the American one.

Lastly, the incentives for the stakeholders might differ in companies with dissimilar debt structure. This refers to companies with several creditors and also to companies with different types of debt (for example corporate bonds). Creditors of such firms are not expected to behave in the same ways as the Swedish banks in our study, since they seldom hold as large positions of debt within a certain company as the Swedish ones do. They are therefore less exposed to the risk of the business defaulting and have fewer incentives to get the company back on track. Also, negotiating difficulties between the different creditors are likely to impede any work-out processes initiated.

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9. Appendix

Appendix one: The interviewees

Name	Date interviewed
Bank employees	
Head of credit committee 1	September 23rd, 2013
Head of credits 1	October 8th, 2013
Head of credits 2	October 15th, 2013
Head of distressed credits 1	September 23rd, 2013
Head of distressed credits 2	October 9th, 2013
Head of distressed credits 3	October 3rd, 2013
Head of distressed credits 4	October 11th, 2013
Head of distressed credits 5	October 25th, 2013
Distressed credit manager 1	October 23rd, 2013
Head of risk 1	September 23rd, 2013
Head of risk 2	October 11th, 2013
Risk manager 1	October 15th, 2013
Loan officer 1	September 13th, 2013
Loan officer 2	October 8th, 2013
Financial advisors	
Financial advisor 1	October 1st and 3rd, 2013
Financial advisor 2	October 10th, 2013
Financial advisor 3	October 10th, 2013
Financial advisor 4	October 10th, 2013
Owners	
Investor 1	October 1st, 2013
Investor 2	October 9th, 2013
Investor 3	October 9th, 2013
Investor 4	October 9th, 2013
Bankruptcy trustees	
Bankruptcy trustee 1	October 10th, 2013
Bankruptcy trustee 2	October 23rd, 2013
Legal advisors	
Legal advisor 1	
Legal advisor 2	October 23rd, 2013
Professor	
Strömberg	September 20th, 2013

Appendix two: The interview questions serving as a guide during our interviews

To begin with, we made sure to highlight that we focused on medium sized companies with one bank and all answers would remain anonymous

Overarching questions

- General responsibilities of the interviewee
- Background: previous employers, years in specific company, experience from working with companies in financial distress

Swedish banks

- The business model of Swedish banks
- How the business model has changed throughout the years
- Most important aspects of Swedish banking
- The role of credit losses and relationships
- Differences in how varying organisations act
- Differences compared to international banks
- Other sources of credit in Sweden

Financial distress

- Reasons for companies being in financial distress
- How to notice companies in financial distress
- At what point banks take action
- Reasons for the banks to terminate or retain the relationship with a financially distressed company
    - The impact of different factors
- How Swedish banks act when an existing borrower is in financial distress
    - Depending on how severely distressed the company is
    - Depending on it they want to terminate or retain the relationship
- The banks' power to demand certain changes to be made within the company
- The role of the bank in mitigating the financial distress
- Concessions made by the bank
- Concessions made by the owners

Bankruptcy

- Perception of the Swedish bankruptcy legislation
    - Previous experience from companies filing for bankruptcy or formal restructuring
    - Comparison to other countries
    - Who files for bankruptcy