Evergreening

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Abstract

We develop a simple model of relationship lending and show that lenders have an incentive to evergreen loans by offering better terms to less productive and more indebted firms. We detect such lending distortions using loan-level supervisory data for the United States. Low-capitalized banks systematically distort their risk assessments of firms to window-dress their balance sheets and extend relatively more credit to underreported borrowers. Consistent with our theoretical predictions, these effects are driven by larger outstanding loans and low-productivity firms. We incorporate the theoretical mechanism into a dynamic heterogeneous-firm model to show that evergreening can affect capital misallocation and aggregate output.