Door: **Dr. S.R.G. Ongena**

Benefits and Costs of Bank **Relationships**

INTRODUCTION

As a bank provides a set of services through time to a customer, it gains substantial knowledge about the customer and its financial needs. The bank can use this inside information to establish a close relationship with the customer. This relationship can, in turn, lead to benefits for both the customer and the bank. For example, as a bank learns more about a customer's payment pattern, it can tailor contracts to directly suit the financial needs of the customer. A loyal customer will be more willing to purchase all of its financial products from the bank it trusts, aiding the bank in the marketing of profitable new products. Indeed, as the Chase Manhattan motto suggests, bankers often perceive the creation of a strong customer *relationship* to be a core element of the services they offer.

Despite the perception of its importance, the value in a modern economy of a close relationship between the bank and customer is uncertain. Many of today's financial transactions are executed via automated, anonymous markets that require little relationship-building. The global trends toward deregulation, disintermediation and securitization appear to only have accelerated the transition from relationship-intensive services to more market- or transactions-oriented financial products. Yet relationship-intensive financing may remain a fundamental ingredient in the nurturing of developing firms and economies.

This primer briefly reviews the theoretical literature dealing with the costs and benefits of bank relationships. As such, this primer draws extensively on Ongena and Smith [2000], who review recent empirical papers dealing with bank relationships. Other introductions to this literature include Berlin [1996], Grout [1997], Ongena [1999], and Rivaud-Danset [1996], among others. Boot [2000] and Degryse and Ongena [1999] review the importance of bank relationships for the competitive nature and the structure of financial markets. Bhattacharya and Thakor [1993], Bernanke [1993], Scholtens [1993], and Freixas and Rochet [1997], among others, contain broader coverage of current research issues in banking. The rest of this primer is organized into four sections. Section 2 begins by defining a bank relationship. Section 3 discusses the benefits of a bank relationship for the firm, while Section 4 lays out the potential costs. Section 5 concludes.

DEFINITION OF A BANK RELATIONSHIP

In its most fundamental form, a *bank* is an institution whose primary activities are the granting of loans and the taking of deposits from the public. As an intermediary between individuals wishing to save and those that want to borrow, a bank is strikingly similar to a securities market. The bank creates and exchanges financial contracts to facilitate the movement of funds between savers and borrowers. Historically speaking, a bank has also provided liquidity and safety not available through securities markets.

Indeed, a bank is expected to "lean against the wind" and accommodate its debtors during difficult financial times. Such flexibility is typically not available in an anonymous securities market. To ensure its credibility as a savings institution, abank is also expected to quickly redeem deposits to savers *on demand.* This ability to continuously offer liquidity to both borrowers and savers also distinguishes a bank from "arm's-length" securities markets (Rajan [1997]).

Providing financial flexibility requires a close association between the bank and each of its customers. Such an association can be termed a relationship. In its most general form,0ngena and Smith [2000] define a bank relationship to be the connection between a bank and customer that goes beyond the execution of simple, anonymous, financial transactions. The benefits of a relationship may include the transfer of proprietary information, a commitment to continue doing business together through financially tough times, or the offer and delivery of services at prices different from costs. A bank relationship can be more specifically defined along two dimensions. The first is time. The importance of a relationship will depend on the length or duration of the interaction between the customer and bank. The second dimension is scope, which pertains to the breadth of services offered by the bank to its customer.

Maintaining a relationship often means that the customer and bank are willing to make temporary sacrifices in favor of obtaining future benefits. For example, a bank may attract borrowers by offering up-front interest rates that are below-cost, with the hope of charging higher rates to the same customers later to recoup initial losses. Conversely, a firm may be willing to initially accept above-cost interest loans, if a long relationship promises a lower permanent rate in the future. Such pricing decisions may influence the expected duration of the bank relationship. The bank could also offer below-cost loans to a customer, with the hope of recovering the losses through customer purchases of other services from the bank. Such pricing decisions then impact the scope of the relationship.

BENEFITS OF A BANK RELATIONSHIP FOR THE FIRM

This section discusses four reasons for why bank relationships improve financing possibilities, creates value, and ultimately, may improve firm performance. Bank relationships improve contracting flexibility between the customer and bank, reduce agency problems through increased control by the bank, enable reputation-building by the firm, and ensure confidentiality of the financial transactions between the bank and the firm.

First, armed with the information it privately observes, a bank can exploit the length of a relationship to increase *ex-ante* loan contracting flexibility (Boot and Thakor [1994]). As such, bank can provide more complex and non-standard credit products (Bernanke and Gertler [1985]). In addition, increased debt contract flexibility may lengthen the firm's investment horizon (Von Thadden [1995]). Indeed, periodic monitoring and the possibility for the bank to grant or deny continuation may induce firms to avoid myopic investment behaviour. That is, firms may avoid projects which only provide positive returns later on. Such myopia may be present in public market contracts (Porter [1992] makes this argument with respect to the Anglo-Saxon reliance on equity markets).

Second benefit: bank relationships not only allow for more flexible *ex-ante* contracting, they may also increase the ease with which contracts can be renegotiated *ex-post.* For a firm experiencing difficulty meeting contracted loan payments, a bank can re-adjust the terms of the contract and either accommodate the firm with new lending or refuse future lending, conditional on actions taken by the firm during and after the distress period. Thus, banks have the ability to exert control over the management of firm assets, which may provide the proper incentives to firm managers (Rajan [1992]). As such bank debt seniority may play an important role in encouraging the formation of ongoing bank-firm relationships. As senior creditors, banks will benefit first from additional investment in a distressed firm. Hence banks will have incentives to build relationships that allows them to determine the value of such investment (Longhofer and Santos [2000]).

Third advantage: since repeated lending from a bank provides credible certification of payment ability, borrowers may establish a relationship in order to gain a reputation for making timely loan payments. Reputational concerns can therefore influence a firm's choice between bank financing and arm's-length financing. Reputation-building through bank borrowing may serve as a means for establishing enough credibility to eventually borrow through public markets (Diamond [1991]). Higher quality firms care most about establishing a reputation and find it therefore most costly to default on a monitored bank loan. Eventually, a high quality firm's reputation grows to such an extent that the cost of default - through loss of reputation - is so high that the firm can seek unmonitored, public debt.

Finally, bank relationships also enable a firm to obtain financing without disclosing valuable information to the public (Campbell [1979]). The confidentiality of bank lending may protect proprietary information and facilitate screening and monitoring. Improved confidentiality encourages investment in research and development (R&D), when public disclosure of accumulated R&D knowledge creates a free-rider problem (Bhattacharya and Chiesa [1995]). In addition, high-quality firms will choose bilateral bank financing to avoid information leakage through multilateral or public financing which may trigger aggressive behavior of product market competitors (Yosha [1995]), unless firms can control how much information is collected by the banks (Von Rheinbaben and Ruckes [1998]).

THE DARK SIDE OF BANKING

The ability for a bank to privately observe proprietary information and maintain a close relationship with its customer can also impose important costs on the customer. Long-term bank relationships arise in a competitive loan market because an incumbent bank has the ability to offer only above-cost loans to its best customers and holdup customers from receiving competitive financing elsewhere (Sharpe [1990], Fischer [1990], Von Thadden [1998]). The incumbent bank gains this monopoly power through its informational advantage over competitors. A high-quality firm that tries to switch to a competing uninformed bank is pooled with low-quality firms and is offered an even worse, break even interest rate. Other holdup costs arise because the bank has often the power to withdraw financing when it perceives the firm to be inadequately managing the financed assets. This degree of control may reduce *ex-ante* the incentives of the firm managers to exert effort in managing the assets (Rajan [1992]).

The extent to which any one bank can exploit an information monopoly is unclear. Sharpe [1990] predicts that an incumbent bank's monopoly power will be abated by accurate public signals of the firm's ability to pay (i.e. everybody may be able to observe that the firm is prospering). Similarly, the fact that the same inside bank is willing to provide fresh loans may increase the firm's reputation for payment ability, allowing for easier access to public markets, and hence less reliance on bank borrowing (Diamond [1991]). The bank's monopoly power may also be capped by the potential for moral hazard problems associated with asset substitution as the bank charges higher interest rates (Schmeits [1997]): i.e. higher interest rates may

Berlin, M., 1996, For Better and For Worse: Three Lending Relationships, *Federal Reserve Bank of Philadelphia Business Review* November, 3-12.

Bernanke, B.S., 1993, Credit in the Macroeconomy, *Federal Reserve Bank of New York Quarterly Review* 18,50-70.

Bernanke, B.S. and M.Gertler, 1985, Banking in General Equilibrium, University of Wisconsin Press, Madison.

Bhattacharya, S. and G. Chiesa, 1995, Proprietary Information, Financial Intermediation, and Research Incentives, *Journal of Financial Intermediation* 4,328-357.

Bhattacharya, S. and A.V.Thakor, 1993, Contemporary Banking Theory, *Journal of Financial Intermediation* 3,2-50.

Boot, A.W.A., 2000, Relationship Banking: What Do We Know?, *Journal of Financial Intermediation* 9, Forthcoming.

Boot, A.W.A. and A.V.Thakor, 1994, Moral Hazard and Secured Lending in an Infinitely Repeated Credit Market Game, *International Economic Review* 35,899-920.

Campbell, T.S., 1979, Optimal Investment Financing Decisions and the Value of Confidentiality, *Journal of Financial and Quantitative Analysis* 14,232-257.

Chemmanur, TJ.and P. Fulghieri, 1994, Reputation, Renegotiation and the Choice between Bank Loans and Publicly Traded *Debt, Review of Financial Studies* 7, 475-506.

Degryse, H. and S. Ongena, 1999, Bank Relationships and the Structure of Financial Markets, *Mimeo,* K.U. Leuven.

Diamond, D., 1991, Monitoring and Reputation: the Choice between Bank Loans and Privately Placed *Debt, Journal of Political Economy* 99,689-721.

Fischer, K., 1990, Hausbankbeziehungen als Instrument der Bindung zwischen Banken und Unternehmen - Eine Theoretische und Empirische Analyse, *PhD Dissertation,* Universittat Bonn.

Freixas, X. and J.C. Rochet, 1997, Microeconomics of Banking, Massachusetts Institute of Technology Press, Cambridge MA.

Grout, J., 1997, On Banks, in *Managing Banking Relationships,* G. Leahy, Eds. 57-67.

Houston, J.F. and S. Venkataraman, 1994, Information Revelation, Lock-In, and Bank Loan Commitments, *Journal of Financial Intermediation* 3,355-378.

Longhofer, S.D. and J.A.C. Santos, 2000, The Importance of Bank Seniority for Relationship Lending, *Journal of Financial intermediation* 9, Forthcoming.

Ongena, S,, 1999, Lending Relationships, Bank Default, and Economic Activity, *International Journal of the Economics of Business* 6,257-280.

Ongena, S. and D.C. Smith, 2000, Bank Relationships: a Survey, in *The Performance of Financial Institutions,* P. Marker and S.A. Zenios, Eds. Forthcoming.

Padilla, AJ. and M. Pagano, 1997, Endogenous Communication among Lenders and Entrepreneurial Incentives, *Review of Financial Studies* 10,205-236.

Petersen, M.A. and R.G. Rajan, 1995, The Effect of Credit Market Competition on Lending Relationships, *Quarterly Journal of Economics* 110,406-443.

Porter, M.E., 1992, Capital Disadvantage: America's Failing Capital Investment System, *Harvard Business Review* 65-82,

Rajan, R.G., 1992, Insiders and Outsiders: the Choice between Informed and Arm's-length Debt, *Journal of Finance* 47, 1367-1400.

Literatuur

drive the firm to undertake more risky projects.
The information monopoly rents of the inside bank may also be contained by loan commitments (Houston and Venkataraman [1994]), or eroded through market driven information leaks. For example, loan officers may jump ship and join a competitor bank, taking with them valuable customers and inside information about those customers. In addition, banks sometimes voluntarily or with a little regulatory nudging establish information-sharing sources like credit registers (Padilla and Pagano [1997], Van Cayseele, Bouckaert and Degryse [1994]). Such registers will limit the information monopoly of each individual bank to the extent that credit information is reported accurately and timely.

Another seemingly simple solution to the holdup problem is for a firm to establish more than one inside bank relationship and have the banks compete away the monopoly rents. Such competition can be a "double-edged sword" however (Rajan [1992]). Any outside lender that competes with an existing inside bank by offering a lower interest rate at an interim stage of financing will suffer from a winner's curse problem. The inside-bank will offer a competitive bid for good firms while allowing bad firms to take the outside lender's offer (a similar point is made by Von Thadden [1998]). When competition ensues between more symmetrically informed banks, monopoly rents can be eliminated, but only at the expense of reduced control over firm investment behavior. Hence competition at the outset between an insider and outsider has the benefit of reducing the monopoly rent one bank can charge, but also reduces its ability to control the investment behavior of the firm. Moreover, credit market competition may well reduce the availability of credit to firms that benefit most from relationship lending (Petersen and Rajan [1995]).

The costs arising from holdup problems may also be tempered by the bank's desire to build a reputation for refraining from extracting monopoly holdup rents (Sharpe [1990]). Such a reputation may be valuable in attracting future customers. Banks wishing to establish a reputation for financing productive firms, may monitor the firm more intensively, which in turn leads to more efficient continuation decisions in renegotiations (Chemmanur and Fulghieri [1994]).

CONCLUDING REMARKS

Hence according to both practitioner beliefs and recent theoretical papers in banking, it is through the close relationship formed with its customers that a bank distinguishes itself as an independently important, functioning intermediary between savers and users of funds. A relationship can facilitate the screening and pruning of loan customers, reveal information important to establishing future credit terms, and may be an integral part of controlling the behavior of firm managers. The strength of a relationship can be measured by the duration of the relationship through time, and by the scope of services offered by the bank to it customer. Relationships may offer benefits to the firm, but can also impose holdup costs. To empirically determine in which market settings and for which type of firms, relationships are on net beneficial may be a rich avenue for future research.

The authors related to fa departement of finance at fa Faculty of Ecanaaicr and Business Administration of Titbwg University.

'Note: Corporate Slogan, Chase Monhortan Bank

Literatuur

Rajan, R.G., 1997, Is there a Future in Banking? Towards a New theory of the Commercial Bank, *Journal of Applied Corporate Finance*

Rivaud-Danset, D., 1996, Les Contrats de Credit dans une Relation de Long Terme: de la Main Invisible a la Poignee de Main, *Revue Economique* 4937-962.

Schmeits, A., 1997, Discretion in Bank Contracts and the Firm's Funding Source Choice Between Bank and Financial Market Financing, *Mimeo*, Tilburg University,

Scholtens, L.J.R., 1993, On the Foundations of Financial Intermediation: a Review of the Literature, *Kiedit and Kapiwl 26,* 112-141.

Sharpe, S.A., 1990, Asymmetric Information, Bank Lending and Implicit Contracts: a Stylized Model of Customer Relationships, *Journal of Finance* 45,1069-1087,

Van Cayseele, P., J. Bouckaert and H. Degryse 1994, Credit Market Structure and Information Sharing Mechanisms, in Studies *in Industrial Organization*, V. Witteloostuyen Eds. 129-143.

von Rheinbaben, J. and M. Ruckes, 1998, A Firm's Optimal Number of Bank Relationships and the Extent of Information Disclosure, Mimeo, University of Mannheim.

von Thadden, E.L., 1995, Long-term Contracts, Shori-term Investment, and Monitoring, *Review of Economic Studies* 62,557-575.

von Thadden, E.L, 1998, Asymmetric Information, Bank Lending, and Implicit Contracts: the Winner's Curse, *Mimeo*, University of Lausanne (DEEP).

Yosha, O., 1995, Information Disclosure Costs and the Choice of Financing Source, *Journal of Financial Intermediation* 4,3-20.