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Review

A literature survey of value creation through relationship banking

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Relationship banking has emerged as an important mechanism through which banks, especially the smaller ones, overcome problems associated with information asymmetry. Relationship banking also creates value for the borrowing firm through a number of channels such as more chances of loan availability, lower interest rate, and less collateral requirements. In this paper, we provide an overview of the recent literature on relationship banking and its impact on firm value. We also discuss different dimensions of relationship banking to highlight how the role of relationship banking changes in information generation process under different circumstances. Finally, we identify potential areas for future research in this area.

Key words: Banking relationship, firm value, multiple banking relationships, length of relationship, deregulation and technological change.

INTRODUCTION

There are many reasons why financial intermediaries exist. One important reason is their comparative advantage in reducing information asymmetry in financial markets. Information asymmetry refers to a situation where a party does not have sufficient information about the other party to make accurate investment decision. Akerlof (1970) was the first one to identify potential inefficiencies created by information asymmetry in financial markets. Specifically, due to lack of information, a lender might give his funds to an undesirable borrower (adverse selection) or the lender might engage in activities that substantially violate the initial terms and conditions of the loan contract (moral hazards). Banks, an important financial intermediary, have a comparative advantage in reducing these problems through relationship banking and monitoring the activities of the borrowers. Schumpeter (1939) presented the concept of relationship lending and bank monitoring in his famous book, *Business cycle*. According to him, a bank manager is not only supposed to know the type of transaction he is asked to finance and the way the customer will return the loan, but is also supposed to know the customer, his nature of business, and his private habits. The bank can get such information by frequently talking things over with the customer (in other words, by developing a long-term relationship with the customer). A large number of studies support Schumpeter's arguments (Benston and Smith, 1976; Ramakrishna and Thakor, 1984; Allen, 1990; Bhattacharya and Thakor, 1993; Greenbaum and Thakor, 1989; Boot and Thakor, 2000; Elyasiani et al., 2004).

Relationship banking is equally important for both the bank and the firm. It helps a firm in getting the required funds for its operation or expansion, while it helps the bank in getting required information from the firm.

The literature establishes a link between firm value and relationship banking through availability of information about the borrower. In the presence of information asymmetry, long-term banking relationship helps the lender to collect information about the borrower through repeated interactions and the use of multiple services provided over the period of that relationship (Boot, 2000). As a result, the information asymmetry between the borrowers and lenders decreases with the passage of time. Given that, long-term relationship with a bank creates value for the borrowing firm through several channels. First, long-term relationships helps the borrowing firm to access loans at lower rates (Petersen

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and Rajan, 1995), with less collateral or guarantees requirements (Berger and Udell, 1995) as well as with relax terms and conditions of the loan contract (Boot et al., 1993). Secondly, the information collected through repeated transactions over the period of time can be reused for the subsequent loan requests, and thus would help in time and cost saving (Boot et al., 1993). Thirdly, close firm-bank relationship can solve the principal-agent problems and thus, would create value for the firm (Boot and Thakor, 2000).

The primary objective of this paper is to review the existing theoretical and empirical literature on various dimensions of the long-term relationship between banks and firms. Specifically, we are interested in highlighting channels through which long-term banking relationship would create value both for a firm and the bank. We also present evidence on whether multiple banking relationships can create more value.

THE CONCEPT OF RELATIONSHIP BANKING

The basic concept of relationship banking and its impact on the value of a borrowing firm is focused on here. One of the key characteristics of modern banks is their ability to have private information about their borrowers. They get such information through repeated transactions and frequent monitoring of existing loans (Boot and Schmeits, 2006). Moreover, banks use their network of contacts to generate further information. While supporting this view, Bhattacharya and Thakor (1993) provide the most fundamental explanation for the existence of (financial) intermediaries. The information availability mainly depends on close banking relationship with the borrowing firm. According to Boot (2000), “relationship banking is the provision of financial services by a financial intermediary that invests in obtaining customer-specific information, often proprietary in nature; and evaluates the portability of these investments through multiple interactions with the same customer over time and/or across products.”

The afore definition focuses on the two dimensions of the relationship banking, that is, firm specific information available to the banks and multiple relationships with the customer. The first dimension emphasizes on the availability of information created during the screening (Ramakrishna and Thakor, 1984; Allen, 1990) or monitoring the firm operations or projects (Diamond, 1984; Winton, 1995). The second concept in the definition stresses on the importance of multiple relations of the bank with the same customer which creates an additional benefit to reuse the information in other loan contracts (Greenbaum and Thakor, 1989).

However, transaction-oriented concept of banking recommends transaction with single customer or multiple transactions with many customers. Boot and Thakor (2000) suggested that transaction-lending approach focuses more on the transaction rather than on the information-intensive interactions with borrowers. From the point of view of Berger (1999), the relationship banking means that a bank collects information beyond the publically available information. Subsequent discussion shows whether relationship banking can help the bank to get private information.

Relationship banking and private information

Fama (1985) argues that banks can be thought as insider lenders because they have proprietary information about the firm operations as compared to the outside investors, who base their investment decisions mainly on the publically available financial statements. This proprietary information provides unique competitive advantage to banks in the evaluation of the projects and loan contracts. On similar lines, Diamond (1984) argues that financial institutions act as an insider investor so they have competitive advantage over the outsiders in terms of information. James (1987) tested the hypothesis presented by Fama (1985) that if the financial institutions have insider unique information about the firms operations, then the market value of the borrower will increase with the announcement of bank loans. He conducted an event study in order to test for this proposition while taking a data than spanned from 1973 to 1984. His empirical findings suggested that there was a significant positive relationship between the announcement of the bank loans and the stock prices of the firms. However, private placements announcements have negative insignificant and public debts announcements have negative but significant relations with the stock prices of the borrowing firms. These findings suggested that funds provided by a bank and private placements are viewed differently by the stock market. These results were interpreted as banks had more unique information than private equity providers, which is why loan by a bank is considered as positive signal about the future profitability of the firm whereas such signals might not necessarily be generated with private placements.

Lummer and Mc Connell (1989) suggested that if banks have competitive advantage of unique information over the other lenders, it is difficult to find what point in time they have this position. Therefore, they provide two alternative views; firstly, banks have relative advantage before offering of the loans because they have some unique information about the firm. Secondly, the banks may have acquired comparative advantage due to the long-term multiple relationships with their firms. They differentiated between the new loans and renewals of loan contracts. They were of the view that if banks have insider information, then all different types of loan would have positive impacts on firm value. On the hand, if this comparative advantage is due to the long-term relationship than only renewal loans should have positive impact on the firm value. The empirical results suggested that new loans announcements have no significant impact on the firm value. However, the renewal of the loan contracts has significant impact on the stock prices. These results suggested that banks have no comparative advantage over the outsider but they only gain this advantage over a period of time by multiple interactions.

CHANNELS THROUGH WHICH RELATIONSHIP BANKING CREATES VALUE

The impact of the relationship banking on the firm value can be observed through different channels. Banks add value by providing a variety of services at the lowest cost than the individual lenders. Some of the main facilities that can contribute to the value of a firm are summarized based on the past literature.

Availability of funds

Relationship banking plays an important role in information generation and hence in the availability and quantity of credit. Stiglitz and Weiss (1981) suggested that information accessibility plays a vital role in the availability of funds. Besides them, a great deal of theoretical literature is available that claims that financial institution has a potential to generate information about the borrowing firms that is useful in decision-making about the loans contracts (Boyd and Prescott, 1986; Diamond, 1984, 1991; Ramakrishna and Thakor, 1984). Cole (1998) suggested that there is more chance that lender will provide credit to a firm which has pre-existing relationship with the bank.

Relationship banking and information availability are important specifically in the case of small firms when they try to get loans. This is because small firms are more opaque (Stiglitz and Weiss, 1981). Usually, large firms have more information available about them and have a wide variety of avenues to borrow from. Due to availability of information, banks and other financial institutions do not hesitate much to extend loans to large firms (Diamond, 1984, 1991; Leland and Pyle, 1977). Petersen and Rajan (1994) investigated impact of relationship lending on availability of funds to small borrowers. Their empirical results suggested that as relationship with institutional lenders matures, the availability of the funds increases accordingly. Cole (1998) investigated the bank-firm interaction based on the relationship lending and credit availability. His empirical results suggested that lenders provides loan easily to those firms that have pre-existing relationship with the firm.

Williamson (1967) presented a theory of hierarchical control for explaining the difference between small and large bank. According to this theory, in small banks, the lender is either the owner of the bank or may have a close relationship with the bank owner. While in case of large, banks the lenders are not the owners and the bank have many offices. As there is a competition in providing loan in order to get the personal benefits, the lender may provide such loans that are not very productive for the bank. This leads to agency conflicts, therefore, the bank owners are required to make the loan approval process more standardized so as to control this agency conflict.

Berger et al. (2002) suggested that small banks can better handle the loan contracts and information processing of the small firm rather than the large banks. While lager banks do not prefer to finance the operations of firms that are opaque or firms that have less publically available financial information.

Collateral requirements and interest rates

Boot and Thakor (1994) presented a theoretical model to predict the impact of relationship banking on interest rate and collateral requirements. They suggested that as the banking relationship matures, the interest rates decreases and the collateral requirements decline.

However, other studies suggested that initially, the bank charge low rate of interest to the borrowing firms but as the customer becomes loyal, then the bank would charge high rates with the view that the firm will not switch due to the documentation and collateral requirements (Rajan, 1992; Sharpe, 1990; Wilson, 1993).

Several empirical studies have investigated the relationship between relationship banking and terms of the loan, price, and collaterals requirements. Petersen and Rajan (1994) found that relationship lending decreases the loan rate but the relationship was statistically insignificant. Petersen and Rajan (1995) investigated empirically that long-term relationship of the small firms with bank increases the probability of the lower rates on loan contracts. Berger and Udell (1995) found that a long-term relationship with a bank helps the firm in getting loans at lower rate and with less collateral requirements.

DIMENSIONS OF RELATIONSHIP BANKING

Here, we discuss some important dimensions of relationship banking. These dimensions highlight how the role and nature of relationship banking changes under different circumstances. Specially, we focus on length of relationship, multiple-bank relationships, and borrowers distance from the bank.

Length of relationship

The length of relationship banking and the information flows are directly related with each other. The longer is the span of relationship with the borrower, the greater will be the flow of information from the borrower to the lender and higher will be the probability of receiving the loan at a lower rate with minimum level of collateral requirements. Earlier empirical studies evidenced that the probability of loan availability increases with the length of relationship with the lenders (Berger and Udell, 1995; Petersen and Rajan, 1994). According to Boot (2000), as the time of the contract increases, the relationship between the lender and firm also improves and thus, the interest rate and collateral requirements decrease. Degryse and van Cayseele (2000) found that terms of loan contracts are usually strict for relatively unknown borrowers. Similarly, Cole (1998) suggested that there are more chances that a lender will provide credit to a firm that has a pre-existing relationship. He also investigates that pre-existing relation is worthwhile only.

Multiple-banks relationships

Thakor (1996) presented a model where he discussed the implications of relationships with more than one bank (multiple-banks relationships) for price and availability of loans. He argued that the value of proprietary information decreases if more than one bank collects information about the same borrower. This in turn leads to reduction in the loan price. Further, multiple relationships increase the likelihood of loan availability. If one bank refuses to extend loan, the firm can go to other banks and request loans (Petersen and Rajan, 1994). Similarly, Guiso (2000) suggested that firms prefer to keep multiple banking relationships to have stable lines of credit and increases availability of funds for projects that can create value for the firm. He further explained that if a firm has relationship only with one bank and the bank fails to finance the project due to internal banking problems, the firm will approach another bank that might not have information about the firm or its project. The bank will most probably reject the project due to non-availability of quality information (adverse selection) about the project or the firm. Berger and Udell, (1998) further highlight the importance of multiple-banks relationships as they help in generating positive signals to the market. They suggested that a firm with multiple lenders would be desirable compared to a firm with a single lender. If the firm's only lender refuses to extend a loan, it will send a negative signal to the market.

Borrowers distance from the bank

Distance between a borrower and lender plays a vital role in the determination of the contract terms and conditions. In case of small opaque firms, distance becomes more important factor because collection of required information becomes difficult for the lender. If the firm is near to lender then it would be less costly for the lenders to collect information about the firm.

The significance of distance between the lender and borrower has been empirically tested where majority of the studies suggested that distance has been increasing over the period (Cyrnak and Hannan, 2000; Petersen and Rajan, 2002; and Wolken and Rohde, 2002). However, in Belgian bank, Degryse and Ongena (2003) find that distance did not increase over a period of 1975 to 1997. On the other hand, Brevoort and Hannan (2003) suggested that there is no significant increase in the distance between the lender and borrower.

Berger et al. (2002) suggested based on their empirical analysis that the older is the firm the closer would be the bank to the firm. Older firms are closed to banks because at the start of their interaction, a little information was available to the banks about their borrowers.

Cole et al. (2004) suggested that distance is irrelevant as far as loan approval decision is concerned. Degryse and Ongena (2003) conducted a research exploring some importance dimensions of distance in Belgium. They suggested that as the distance between the borrower and lender increases, loan rate decreases. However, competition between the firms for a single bank loan, collateral availability and purpose of loan has significant effects on the loan rate as well as availability of loan (Daniel et al., 2010)

HARD AND SOFT INFORMATION AND RELATIONSHIP BANKING

The major advantage of relationship banking is the reduction in information asymmetry between the bank and the borrower. There is a general understanding among researchers that relationship banking is more important for small firms that do not have sufficient publically available information (DeYoung et al., 2004, Elyasiani, 2004). However, in the following text, we highlight that the nature of information asymmetry may vary from firm to firm in the same country and across countries and hence relationship banking might be important even for large firms in some cases.

In the case of large banks, usually audited and quantifiable information is available (called hard information by DeYoung et al., 2004); whereas, in the case of small and opaque firm, usually the information is in the form of general understanding of the financial health and cash flow positions (soft information, which is not easily quantifiable and cannot be easily communicated). In the case of hard information, information asymmetry might exist primarily in the form of unreliable accounting data (Leuz et al., 2003). This is more likely to be a problem in developing countries where legal protection of investors is weak (La Porta et al., 1998, 2006). Given that, banks need to go beyond the publically available information and collect additional information to get a true picture of the firm. The bank can do so through relationship banking. This highlights that relationship banking is needed both for small and large firms in countries where

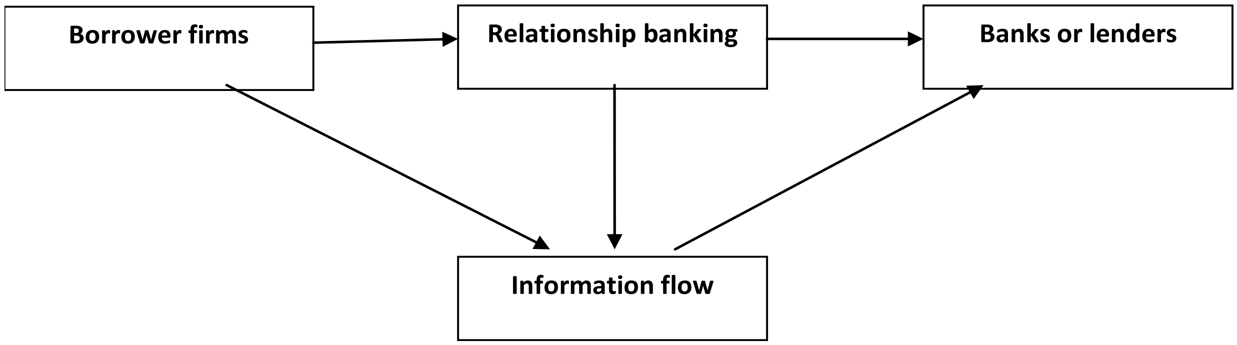

Figure 1. Relationship framework of firm and lender.

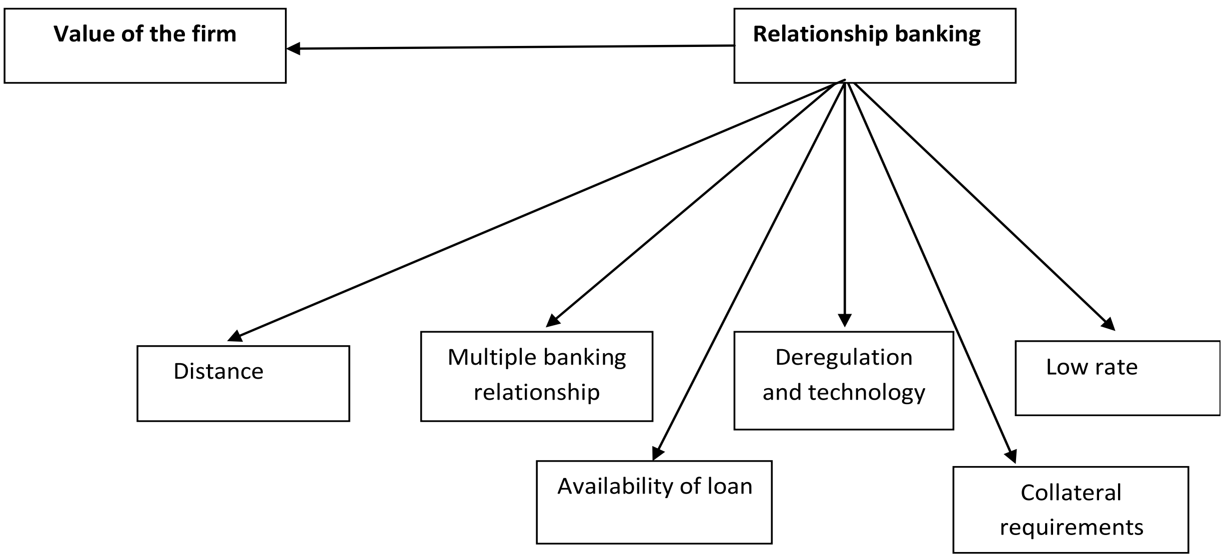

Figure 2. Dimensions of relationship banking and firm value.

legal or judicial systems are weak.

SCHEMATICS OF RELATIONSHIP BANKING AND FIRM VALUE

Based on the afore-cited literature, the intensity of the interaction (that is, number of transactions or different services availability) between the borrowing firm and lender is based on quality of the relationship. If there exists a long-term relationship between the firm and the lender, then more information will be available to the lender about the browning firm. The information availability would help the borrowing firm in getting loans at a lower rate, with less collateral and guarantee requirements. Figures 1 and 2 show the schematics of these relationships. It shows that when a firm has a long-term relationship with its lender, the information will flow from the firm to the lender and thus the loan as well as monitoring of the firm performance will flow from the lender to the firm. Therefore, the relationship banking and information flows act as an intervening variable between the borrowing firm and lenders.

CONCLUSION AND SUGGESTION FOR FUTURE RESEARCH

Long-term relationship between a bank and a borrowing firm helps in overcoming problems engendered by information asymmetry. Relationship over a long period of time enables a bank to get quality information about a borrower and his investment projects. This helps the bank in denying loans to undesirable customers (avoiding adverse selection problems) and helps the customer in timely availability of credit at lower rate of interest and/or with less collateral requirements. This is why relationship banking is a significant source of value creation both for banks and borrowing firms.

Theoretical origins and subsequent empirical tests in this area are rooted in developed markets. It will be interesting to expand research in this area by focusing on developing economies. Legal and institutional factors have traditionally been found to be different in developing economies. These differences can further enhance the need of relationship-banking in lending decisions. For example, both content and enforcement of law are not much conducive for investors in developing countries. In poor a judicial system, it is expected that the cost of adverse selection can be high as lenders will find it costly and time consuming to recover the loan amount through judicial process. Thus, inefficient judicial system makes the availability of information more important in lending decisions as compared to an efficient judicial system. This implies that relationship banking would be more important in less developed markets. Such a proposition can be tested in future research by employing cross-country data.

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