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When arm's length is too far: Relationship banking over the credit cycle☆

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ABSTRACT

We conduct face-to-face interviews with bank chief executive officers to classify 397 banks across 21 countries as relationship or transaction lenders. We then use the geographic coordinates of these banks' branches and of 14,100 businesses to analyze how the lending techniques of banks near firms are related to credit constraints at two contrasting points of the credit cycle. We find that while relationship lending is not associated with credit constraints during a credit boom, it alleviates such constraints during a downturn. This positive role of relationship lending is stronger for small and opaque firms and in regions with a more severe economic downturn. Moreover, relationship lending mitigates the impact of a downturn on firm growth and does not constitute evergreening of loans.

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1. Introduction

In the aftermath of the 2007–2008 global financial crisis, small and medium-size enterprises (SMEs) were among the firms most affected by the turn of the credit cycle (OECD, 2015). As fears increased that credit-constrained SMEs could delay the economic recovery, policy makers focused their attention on initiatives, such as subsidized funding and lending schemes, to expand SME finance. Beyond such short-term crisis responses, an open question remains of how best to protect SMEs in a more structural way from the cyclicality of bank lending.

This paper studies whether banks' use of relationship lending techniques influences the cyclicality of credit. Our methodological innovation is to differentiate between relationship and transaction banks by using information on banks' lending techniques from 397 face-to-face interviews with the ultimate bank insiders: their chief executive officers. We find, for a sample of 14,100 firms across 21 countries, that a greater local presence of banks that view themselves as relationship lenders is associated with fewer firms being credit-constrained during a downturn (2008–2009) but not during a credit boom (2005).

The role of relationship lending for firm financing has received ample attention in the literature.[2] Relationship lending, that is, repeatedly interacting with clients to obtain and exploit proprietary borrower information (Boot, 2000), enables banks to learn about borrowers' creditworthiness and to adapt lending terms accordingly (e.g., Rajan, 1992; von Thadden, 1995). It has long been regarded as the appropriate tool for banks to lend to (opaque) SMEs. Attention has turned only recently to the specific role of relationship lending during economic downturns and crises. Theory suggests that relationship lenders can play a role in the continuation of lending during downturns as they can (implicitly) insure against adverse macroeconomic conditions (Berger and Udell, 1992; Berlin and Mester, 1999). Because relationship lenders acquire valuable information during the lending relationship, they can also more easily adapt their lending conditions to changing circumstances (Agarwal and Hauswald, 2010; Bolton, Freixas, Gambacorta, and Mistrulli, 2016). This can allow them to continue to lend on more favorable terms to profitable firms when a crisis hits.

To examine whether the availability of relationship lending techniques co-varies with firms' credit constraints at the peak and the trough of the credit cycle, we combine several data sets. First, we classify banks as either relationship or transaction lenders based on the views of the bank CEO. Banks that view relationship lending techniques as very important when dealing with SMEs are considered relationship lenders. We use detailed credit-registry information from a representative country in our sample (Armenia) to show that banks that are classified this way as relationship lenders engage in significantly longer and broader lending relationships, deal with smaller clients, and are less likely to require collateral. These results are in line with the previous empirical literature on relationship lending (e.g., Petersen and Rajan, 1994; Berger and Udell, 1995; Degryse and Van Cayseele, 2000) and indicate that the lending practices of a bank reflect whether the CEO considers relationship lending to be important.

Second, we merge information on bank-lending techniques with firm-level survey data on financing constraints of 14,100 businesses and with hand-collected information on the location of 38,310 bank branches across 21 countries in emerging Europe. These combined data allow us to capture the type of banks that surround each firm and to measure, at the local level, the link between banks' views on the importance of relationship lending and firms' financing constraints at the peak and trough of the credit cycle.

We find that a greater presence of relationship banks is associated with fewer nearby firms being credit-constrained in 2008–2009, when the credit cycle had turned, but not in 2005. This holds after controlling for characteristics of the local banking landscape, such as banks' funding structure and local competition, and for various firm characteristics. This result is also robust to a range of specification tests and ways to address endogeneity. For 2008–2009, we find that the link between relationship banking and relaxed credit constraints is stronger for young, small, and non-exporting firms, firms with no other sources of external finance, and firms that lack tangible assets, i.e., firms that are more opaque and more likely to be constrained in a downturn.

These findings are consistent with the hypothesis that relationship lending, as measured by our novel indicator of a bank's business model, can be critical for alleviating firms' credit constraints during a credit cycle downturn. We present additional evidence suggesting that the loosening of credit constraints does not reflect the evergreening of loans to under-performing firms. In contrast, the beneficial role of relationship lending is concentrated among relatively safe firms and is positively linked to firm investment and growth after the turn of the credit cycle. Our findings are therefore in line with the helping hand hypothesis, which highlights the beneficial role of relationship lending (Chemmanur and Fulghieri, 1994), instead of the zombie lending hypothesis whereby banks keep inefficient firms alive (Peek and Rosengren, 2005; Caballero, Hoshi, and Kashyap, 2008).

Our paper contributes to a growing literature on the role of relationship lending during economic downturns and crises. A first set of papers builds on the seminal contribution of Petersen and Rajan (1994) and focuses on individual firm-bank relationships. These papers typically use loan or loan application data from credit registries to identify the impact of firm-bank relationships on access to credit within a particular country. For Spain, Jiménez, Ongena, Peydró, and Saurina (2012) show that when gross domestic product growth is low, banks are more likely to continue to lend to long-term clients. For Germany, Puri, Rocholl, and Steffen (2011) find that savings banks affected by the subprime crisis started to reject more loan applications but did so to a lesser extent for existing retail clients (those with a checking account). For Portugal, Iyer, Peydró, da-Rocha-Lopes, and Schoar (2014) show that banks with

[2] Degryse, Kim, and Ongena (2009) and Kysucky and Norden (2016) review the literature on relationship lending and its effect on firms' access to credit during normal times.