



THE BANK FIRM RELATIONSHIPS

How should a small firm manage its bank relationships and how should it structure its bank pool?



THE BANK FIRM RELATIONSHIPS

- If you manage a small firm:
 - What could you expect from relationship banking?
 - How many banks should you work with?
 - How to choose your main bank?



1-ON RELATIONSHIP BANKING

- What is relationship lending?
 - The most powerful technologie available to reduce information problems in small firm finance
 - Under relationship lending, banks acquire information over time through repeated contacts with the firm
 - Relationship lending is opposed to transaction lending (one shot)



1-ON RELATIONSHIP BANKING

- How to characterize relationship lending between a firm and a bank?
 - Through a variety of contacts over time
 - Through the provision of loans
 - Through deposits and other financial products
 - By the low number of the firm's banks
 - By the existence of a main bank



1-ON RELATIONSHIP BANKING

- How to legitimate relationship lending?
 - The Leland-Pyle model legitimates relationship banking rather than transaction banking
 - Relationship banking leads to a reduction of information asymmetries (adverse selection and moral hazard)
 - That means better credit contracts for good firms



1-ON RELATIONSHIP BANKING

- What to expect from relationship lending? The firm viewpoint.
 - A best credit availability
 - Smaller collateral requirements
 - The effect on interest rate is ambiguous
 - Because of the hold-up problem
 - Relationship Banking means an informational monopoly
 - The hold-up problem mitigates the positive effect linked to the reduction of information asymmetrie



1-ON RELATIONSHIP BANKING

- What to expect from relationship lending?
 - Smooth conditions over the business cycle
 - A stronger support from the main bank in case of financial distress



1-ON RELATIONSHIP BANKING

- How to link the bank market structure and relationship banking?
 - On one hand, in a more competitive market, the benefits from relationship lending are less important (Petersen et Rajan, 1995)
 - On the other hand, in a more concentrated bank market, bank organizational structures are less adapted to develop relationship lending (Strahan et Weston, 1998)



2-TOWARD A THEORY OF THE OPTIMAL NUMBER OF BANKS

- Two approaches of that problem:
 - The transaction cost approach
 - The creditors coordination approach



2-TOWARD A THEORY OF THE OPTIMAL NUMBER OF BANKS

- 1-The transaction cost approach
 - Detragiache and al, 2000
 - Hypothesis
 - Contracting with a bank is costly in $t=0$;
 - Banks are subject to an illiquidity risk (exogenous in $t=1$)
 - Unless the firm has contracted in $t=0$ with a bank, the firm risk is unknown from the other banks in $t=1$



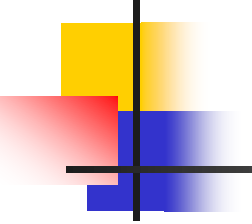
2-TOWARD A THEORY OF THE OPTIMAL NUMBER OF BANKS

- 1-The transaction cost approach: results
 - The optimal number of banks is the result of a trade-off between:
 - The transaction costs, increasing with the number of banks
 - The credit rationing risk in $t=1$ if the relationship banks are illiquid
 - If so, the firm has to contact another bank in $t=1$ (a transaction bank) which can suspect that the firm is a bad one (adverse selection effect)



2-TOWARD A THEORY OF THE OPTIMAL NUMBER OF BANKS

- 1-The transaction cost approach: results
 - If the adverse selection effect in $t=1$ is important, the firm should choose multiple bank relationships in $t=0$, despite high transaction costs
 - $N^* = f\{\text{adverse selection effect, bank fragility, transaction costs}\}$



2-TOWARD A THEORY OF THE OPTIMAL NUMBER OF BANKS

- 2-The creditors coordination approach
 - Welch and Bris, 2002
 - Hypothesis
 - In case of default, the shareholders can violate the « absolute priority rule », despite they are residual claimants
 - If they coordinate themselves, creditors can prevent such a behavior from shareholders
 - Creditors coordination is costly and difficult because of « free riding »



2-TOWARD A THEORY OF THE OPTIMAL NUMBER OF BANKS

- 2-The creditors coordination approach: results
 - The entrepreneur should choose a high number of creditors (public debt)
 - With information asymetrie about the firm risk, the entrepreneur can signal his risk with a high level of debt concentration
 - Signal is costly but marginal cost is decreasing with firm quality
 - $N^* = f\{\text{firm's quality}\}; f' < 0$



2-TOWARD A THEORY OF THE OPTIMAL NUMBER OF BANKS

- An empirical study: Ongena and Smith, 2000
 - 1129 european firms in 1996
 - South European countries=high number of banks (Italy=15 banks)
 - North European countries=low number of banks (2 banks in Norway)
 - $N^* = f\{\text{country law; banks fragility; firm size; debt/equity ratio; type of the main bank}\}$



3-HOW TO CHOOSE THE MAIN BANK?

- 2 questions:
 - How to choose the main bank?
 - How to structure the firm's bank pool?



3-HOW TO CHOOSE THE MAIN BANK?

- 1-How to choose the main bank?
 - From Berger and Udell (2002), and the pioneering work of Stein (2002)
 - Starting point is the difference between relationship lending (RL) and transaction lending (TL)
 - RL is based on soft information (such as reliability)
 - TL is base on hard information (financial ratios)



3-HOW TO CHOOSE THE MAIN BANK?

- 1-How to choose the main bank?
 - Soft information is not easily checkable
 - Transferring soft information in the bank hierarchy (from the loan officer to the bank's senior management) implies high agency costs
 - So, banks offering relationship lending must delegate more lending authority to their loan officers
 - In turn, this delegation may exacerbate agency problems: overinvestment in generating new loans (overlending)



3-HOW TO CHOOSE THE MAIN BANK?

- 1-How to choose the main bank?
 - The magnitude of contracting problems depend heavily on the complexity and size of the banking institution
 - Hierarchical banks (more complex and larger) may be at a disadvantage in transmitting soft information associated with RL
 - This could lead large banks to adopt standardised credit policies based on hard information and TL



3-HOW TO CHOOSE THE MAIN BANK?

- 1-How to choose the main bank?
 - On the opposite, small banks, with few layers of contracting, can engage in RL without incurring high agency costs



3-HOW TO CHOOSE THE MAIN BANK?

- 1-How to choose the main bank? Conclusions
 - Small banks should specialise in RL
 - Larger and more complexe banks should specialise in TL
 - Small firms, characterised by soft information and relying on RL, should choose small banks as their main banks
 - Large firms, relying on TL, can choose large banks



3-HOW TO CHOOSE THE MAIN BANK?

- 2-How to structure the firm's bank pool?
 - Empirical studies confirm 2 hypotheses:
 - The « single-bank firm opacity hypothesis »
 - More opaque firms should concentrate their bank debt on their (one) main (small) bank
 - The « multiple-bank bank distress hypothesis »
 - Firms should compensate a more fragile main bank by several (2 or 3) secondary banks (Detragiache)



SUMMARY

- RL is the most powerful technologie to reduce information asymetries in small firms finance
- RL leads to more efficient credit contracts
- Small banks specialise more easily in RL while larger banks can specialise in TL
- Small firms should choose a small bank as their main bank
- The optimal number of banks depend on adverse selection effect, bank fragility and transaction costs



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