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Relationship banking

Informational advantage

- ▶ Customers are loyal to their banks for long periods of time, switching banks is not common
- ▶ Banks can accumulate information on customers, especially soft information such as management skills or reliability
- ▶ This gives the bank an informational advantage over competitors
- ▶ This is referred to as relationship banking

Implications of relationship banking

- ▶ Relationship banking will affect the loan conditions, especially the loan rate, as competition will be limited
- ▶ With an existing loan, it may also affect the willingness of a bank to provide new loans to their existing customer
- ▶ Increased competition between banks might affect the ability to engage in relationship banking

Using the informational advantage

- ▶ If banks accumulate information, they are able to price a loan better than their competitors, making excess profits
- ▶ Once in a relationship, banks can exploit their advantage and charge loan rates above their costs
- ▶ Knowing this, banks will take this into account when attracting new customers



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Chapter 10.1.2
Exploiting informational advantage

Discussion of model results

- ▶ Banks exploit their informational advantage by charging non-competitive loan rates and make excess profits
- ▶ These excess future profits lead to more intense competition to attract customers through low initial loan rates
- ? Can banks make excess profits by offering introductory offers for the first loan and then charge higher loan rates for many loans afterwards?
- ! The future profits from these higher loan rates will be taken into account when making the introductory offer, eroding any excess profits

Extending loans

- ▶ A company facing bankruptcy after a bad investment might not be able to repay its existing loan
- ▶ A bank could provide a new loan and hope that the profits from this loan reduces their losses
- ▶ Banks could extend loans to otherwise bankrupt companies in the hope of recovering more monies in the future
- ▶ This is referred to as evergreening



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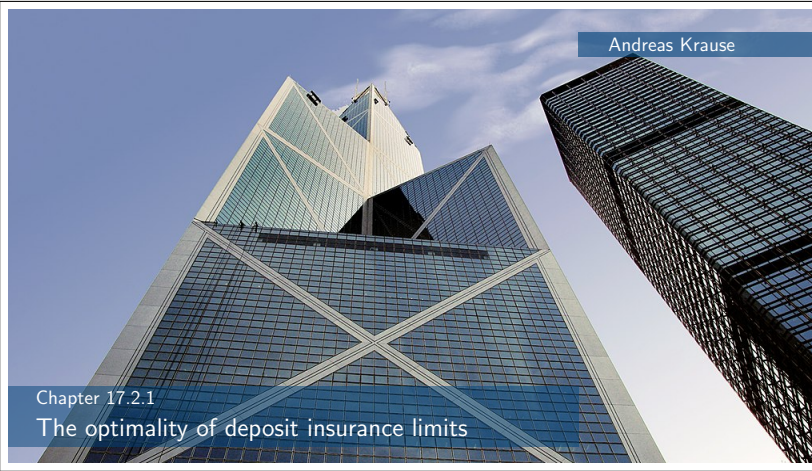
Chapter 10.2.3
Evergreening

Discussion of model results

- ▶ Provided the outstanding loan is not too large, existing banks would advance new loans to recover any losses, while new banks would not do so
- ▶ Relationship banks may advance loans to companies that will generally be seen as not creditworthy
- ? In what way can extending a loan to a not-creditworthy company be negatively affecting other creditors?
- ! Extending loans by the existing bank can be interpreted as a signal that the loan is sufficiently safe and a less sophisticated creditor might follow the lead of the bank; the higher claim of the bank in a final default may dilute the claims of other creditors

Costs of relationship banking

- ▶ Accumulating information is costly and banks need to be able to recover such costs
- ▶ If competition between banks increases, their profits should decrease, making the recovery of such costs more difficult
- ▶ But as relationship banking also provides an informational advantage, the overall effect may be ambiguous



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Chapter 10.3.1
Adverse selection and competition

Discussion of model results

- ▶ Increased competition makes profits from relationship banking more important for banks as they cannot be competed away
- ▶ More intense competition should increase the prevalence of relationship banking
- ? Would more competition affect loan rates in relationship banking?
- ! The informational advantage is retained and therefore not affected by competition; competition will reduce loan rates to attract new customers

Summary of key results

- ▶ Relationship banking allows banks to make excess profits in such a relationship, but it will also increase competition for new customers
- ▶ Banks may extend loans to companies that are not credit-worthy with the aim of reducing losses from existing loans
- ▶ Competition between banks increases the importance of relationship banking to generate profits
- ▶ Relationship banking makes an important contribution to the profits of banks



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