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The Political Economy of Relationship Banking

Igor Lončarski[a] and Matej Marinč[b]

Abstract

In the aftermath of the global financial crisis, banks need to reevaluate their position in light of profound changes in the economic, social, and political landscape. On the one hand, we emphasize the benefits of relationship banking, which establishes close contact with bank customers. Through a long-term orientation, relationship banking aligns incentives and supports the long-term needs of bank customers, leading to reduced inequality and greater firm innovation. On the other hand, the interaction between politics and relationship banking can have dark sides. First, with new borders arising and competition in banking affected, relationship banking might be particularly prone to political interference. Second, a shock to the relationship bank can be transmitted to its borrowers. We analyze how relationship banking can overcome its drawbacks.

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Keywords Banking, Relationship banking, Financial crisis, Political interference, Politics

[a] University of Ljubljana, School of Economics and Business, Kardeljeva ploščad 17, 1000 Ljubljana, Slovenia; igor.loncarski@ef.uni-lj.si; ORCID: 0000-0003-3143-3805
[b] University of Ljubljana, School of Economics and Business, Kardeljeva ploščad 17, 1000 Ljubljana, Slovenia; matej.marinc@ef.uni-lj.si; ORCID: 0000-0003-1472-3907

"Nobody knows banking better than I do." —US President Donald J. Trump, February 2016

1. Introduction

In the aftermath of the global financial crisis, banks need to respond to the profound changes in the economic, social, and political landscape. Economies are driven by innovations and strained by rising inequalities and pronounced business cycles. Societies are on the verge of deep transformation in light of transformative political dynamics. Political forces are changing the perception of borders, where internationalization might acquire a more negative connotation. Understanding the role of banking in a changing political environment is a challenge.

Banks' raison d'être resides in mitigation of information asymmetry between investors and borrowers (Diamond, 1984; Greenbaum, Thakor, and Boot, 2019). Banks assess the quality of their clients, whose goals and incentives may substantially differ from those of the banks, and produce information about their creditworthiness. We argue that, in an environment filled with information asymmetries, relationship banking presents a competitive advantage to the bank. Relationship banks engage in long-term cooperation with their clients and, by doing this, form close ties with their clients based on soft information that is difficult to quantify (Boot, 2000; Liberti and Petersen, 2017).[3] To better employ soft information, a relationship bank retains a high degree of flexibility and discretion, supported by confidentiality and trust.

We argue that the features of relationship banking make banks well suited to tackle several economic and social challenges. Relationship banking works to support local economic growth and provide credit to small and medium-sized firms, the poor, and minorities, all leading to reduced inequality in the economy. By lowering information asymmetries, relationship banking also facilitates the financing of innovative firms.

[3] The literature on relationship banking goes back to James (1987), Petersen and Rajan (1995), Boot (2000), and Boot and Thakor (2000), and it flourished especially after the recent financial crisis. Whereas Jakšič and Marinč (2018) analyze the impact of information technology on relationship banking, our focus is on the interconnection between relationship banking and political and social forces.

However, relationship banking is not necessarily only beneficial, but may also entail costs and face several challenges, especially in the presence of a financial crisis and a changing political environment.

The first drawback of relationship banking relates to the "hold-up problem," in which relationship banks predominantly employ proprietary information for their own benefit, tying their borrowers to themselves (Sharpe, 1990; Rajan, 1992). The costs of relationship banking then stem from excessive lending rates. In addition, a bank-dependent borrower may run into funding problems if its bank suffers in a financial crisis. The question then is whether relationship banks can support their long-term customers through the crisis. The suggestion is that relationship banking may enhance stability in banking.

The second drawback relates to the vulnerability of relationship banking to political pressures. For decision-making based on soft information, discretion and flexibility are a must. In such an environment, political interference is difficult to prevent. Close ties between a bank and its customers may then be used for the benefits of political cronies rather than to mitigate information asymmetries. We evaluate how relationship banking might be affected by political interference, a changed competitive landscape, and raised borders.

This article is organized as follows. Section 2 defines relationship banking and surveys external forces in the banking environment. Section 3 reviews the main theories of relationship banking and analyzes whether relationship banking can lower economic inequality and support innovations. Section 4 discusses the role of relationship banking during the financial crisis and its aftermath. Section 5 analyzes how political interference affects relationship banking. Section 6 concludes the article.

2. Relationship banking and external forces in banking

After defining relationship banking, several forces are described that shape the banking environment, including the global financial crisis, looming economic inequality, striving for innovation, political changes, and IT developments.

2.1. Defining relationship banking

Financial intermediaries help smooth the interactions and transactions among users and providers of financial capital (Greenbaum, Thakor, and Boot, 2019). For example, a commercial bank collects withdrawable deposits to fund illiquid loans, in which the illiquidity of loans stems from the information asymmetry between banks and their borrowers. Proprietary information that banks obtain through screening and monitoring yields a distinct competitive advantage and is related to relationship banking.

Relationship banking denotes the type of activity in which banks repeatedly transact with customers across several services, products, and/or access channels to obtain and exploit proprietary information—often non-quantifiable or soft in nature—to form close ties with their customers (Boot, 2000). A typical example is a small commercial bank that approves a line of credit to a long-term small borrower. In contrast, transaction-oriented banking denotes services that need only a one-time interaction with a bank client; for example, arranging an IPO for a large firm.

Strictly distinguishing between relationship banking and transaction banking is not always straightforward. Soft and hard information can simultaneously be used in relationship and transaction banking lending techniques. Transaction lending technologies, such as small business credit scoring, financial statement lending, asset-based lending, fixed-asset lending, factoring, leasing, and judgment-based lending, give distinct advantages to a bank, including support for lending to small and medium-sized firms (Berger and Udell, 2006; Berger and Black, 2011). For example, a loan officer draws on his experience and training to make judgment-based lending decisions. Similarly, whereas core relationship lending builds on the use of soft information, quantifiable information may be simultaneously employed.

We also acknowledge that relationship banking is not limited to relationship lending but extends to other banking activities that demand long-term relationships. A bank obtains proprietary information about its depositors through their deposit-taking activities and payment transactions data (such as cash inflows, credit line usage, and limit violations; see Norden and Weber, 2010).

Even investment banks form relationships with their clients (e.g., in the merger and acquisition advisory business; Francis, Hasan, and Sun, 2014).

2.2. The financial crisis and bank regulation

Banks are crucial for the smooth operation of the real economy. Through deposit-taking activity, banks provide safe storage of money and create liquidity, mobilizing resources that can be used for lending. Through screening and monitoring activities, banks improve the allocation of capital in the economy. Banks also operate the payment system and support the central bank in its monetary role.

The global financial crisis demonstrated how crucial stability in banking is and how vast the negative externalities of bank failure can be. The global financial crisis has been commonly perceived as the worst financial crisis since the Great Depression of the 1930s (Thakor, 2015). Banks engaged in excessive risk-taking activities in their drive for profits. Bank failures contagiously spread across banking systems, invoking full-blown systemic crises with devastating costs for the global economy.

Negative externalities of bank failures justify the existence of an extensive safety net—including deposit insurance schemes, central bank liquidity support, and implicit or explicit government intervention—that by itself can further fuel incentives for bank risk-taking. In the aftermath of the global financial crisis, the bank regulatory framework has been overhauled. Basel III capital regulation imposes higher requirements for high-quality capital and newly established liquidity requirements. The focus has shifted from microprudential regulation that safeguards the stability of each bank separately to macroprudential regulation that safeguards systemic stability. In addition, policymakers increasingly distinguish between banking operations (e.g., payment system, deposit-taking activities, and retail operations) that are crucial for smooth operation of the real economy and risky banking operations (e.g., investment banking, trading, and bank activities on financial markets), in which government support is not needed and might be abused for profiteering purposes.

2.3. Economic challenges of society and political changes

Societies are facing substantial economic challenges that are difficult to address due to their long-term nature and due to the political strains that they provoke. Societies have become stifled by substantial inequalities. The benefits of economic growth may be unequally spread among different regions and across populations. Following Piketty (2015), who analyzes the role of institutions—such as the welfare state, free education, or progressive taxation—on welfare inequality, we ask whether there is a connection between relationship banking and inequality. Can relationship banking reduce inequality by lowering information barriers and facilitating access to credit in underdeveloped regions for the poor and minorities, who typically lack good collateral and an established credit history?[4]

Related to this, innovativeness has become perceived as crucial for sustainable economic growth (Gordon, 2012). The question is how to provide funding to support investments in innovation. Some have argued that innovations have most benefited those that make the greatest investments in innovations (Lazonick and Mazzucato, 2013). For example, an employee at a large company can devote his overtime work to a new innovation only to see its benefits being extracted by the top management through their option-based bonuses, whereas the employee can even be fired in the cost-cutting process. Overreliance on stock markets and short-termism enhance such transaction-driven behavior and may even suppress innovations. Lazonick and Mazzucato (2013) call for the development of business organizations that focus on inclusive, long-term growth based on a proper reward for value creation.

Spurred by rising inequality, unemployment, and immigration, and further fueled by the financial crisis, the political landscape in several countries is reconfiguring. Protectionist policies may seek to reverse globalization with a return of exogenous borders that limit internationalization and competition. As summarized by Ruta (2005), when the heterogeneity of citizens increases, the

[4] This view connects relationship banking to the literature on financial development and inequality (Beck, Demirgüç-Kunt, and Levine, 2007; Claessens and Perotti, 2007).

associated political costs of integration may surpass the economic benefits of political integration and disintegration may ensue.

Our aim is to review how relationship banking addresses the aforementioned economic and political challenges delineating the benefits of relationship banking from the challenges that it faces.

3. The economic benefits of relationship banking: limiting inequality and supporting innovativeness

After reviewing the main foundations of relationship banking, we discuss whether relationship banking can address increasing inequality and support innovation.

3.1. Foundations of relationship banking

Financial intermediation literature has provided several theoretical foundations for relationship banking (Bolton et al., 2016). First, the insurance-based foundation views the main role of relationship banking in insuring firms with future access to banking activities (Berger and Udell, 1992; Berlin and Mester, 1999). In this view, a relationship bank builds on soft, non-contractable information and provides intertemporal smoothing of contract terms. For example, a relationship bank can smooth interest rates through the lifecycle of its borrower (as in Petersen and Rajan, 1995) or through the business cycle (as in Berlin and Mester, 1999).

Second, the ex-ante screening-based foundation of relationship banking proposes that a relationship bank obtains soft, proprietary information about the inherent riskiness of firms before granting them loans (Agarwal and Hauswald, 2010; Puri, Rocholl, and Steffen, 2011). In this view, a relationship bank is characterized by pronounced information acquisition before the lending contract is concluded.

Third, the ex-post screening-based foundation argues that a relationship bank gathers soft information about its clients and acts upon it throughout a long-term relationship (Sharpe, 1990; Rajan, 1992; Von Thadden, 1995; Schenone, 2009; Bolton et al., 2016). For example, a

relationship bank may lend on a short-term basis only to roll over the loan after ascertaining that the borrower is creditworthy.

Fourth, the monitoring-based foundation of relationship banking emphasizes monitoring through which a bank mitigates potential rent-seeking behavior of its borrowers. Typically, monitoring takes place throughout the long-term bank–borrower relationship (Holmstrom and Tirole, 1997; Boot and Thakor, 2000).

A core feature of a relationship bank is the production of soft and proprietary information about its clients with the goal of mitigating potential conflicts of interest. A relationship bank can only act upon soft information if it possesses sufficient flexibility and discretion in its decision-making. A sufficient level of trust is also needed if a borrower is to reveal proprietary information to its bank without concern that such information might be employed against him or transferred to his competitors. The production of soft information can be combined with several contracting features in lending. For example, a loan contract can be very specific and may include detailed loan covenants and firm-specific collateral. The superior monitoring ability of a relationship bank then lies in monitoring loan covenants and the value of the collateral (Boot, 2000).

Several studies point to the synergies between relationship banking and deposit-taking. The combination of lending and deposit-taking is beneficial because banks provide liquidity not only to depositors but also to firms in the form of credit commitments. Knowing that deposit-taking and credit commitment withdrawals are imperfectly correlated, banks can economize on the size of the liquidity reserves that they hold (Kashyap, Rajan, and Stein, 2002). Banks also combine the liquidity provision function of credit commitments with monitoring of their borrowers (Acharia et al., 2014). Song and Thakor (2007) argue that core deposits that act as a stable funding source allow banks to fund long-term relationship loans.

To conclude, the foundations of relationship banking point to the role of soft information production through flexibility, discretion, monitoring of collateral and covenants, and intertemporal welfare transfers across a long-term relationship.

3.2. Determinants of relationship banking

Relationship lending is especially valuable for small, opaque borrowers that have no direct access to financial markets. Bharath et al. (2011) find that repeated borrowing from the same bank leads to 10 to 17 bps lower loan spreads. Past relationships are also associated with lower collateral requirements and larger loan size. Once close bank–borrower lending relationships are formed, their continuation and future lending are very likely (Bharath et al., 2007). The importance of relationship banking is also confirmed by findings that small and medium-sized firms are severely hurt if bank–borrower relationships are terminated (Degryse, Masschelein, and Mitchell, 2011).

The benefits of relationship banking extend not only to small and medium-sized enterprises, but can even occur for investment banking services (Fernando, May, and Megginson, 2012). For example, private equity firms work hand in hand with banks that finance their firm portfolio, and relationships contribute toward lower loan spreads of leverage buyout firms (Ivashina and Kovner, 2011). Another example is microlending, in which relationship intensity improves access to credit and loan approval speed (Behr, Entzian, and Güttlerb, 2011).

A wider question is what economic and social environments warrant relationship banking the most. The literature on the market- versus bank-based financial systems highlights the role of banks in lowering transaction costs associated with vetting and enforcing contracts. Ergungor (2004) finds that financial systems are more likely oriented toward banks in civil-law countries, where civil-law courts have lower flexibility and are consequently less effective in resolving conflicts. In common-law countries, more detailed creditor and shareholder protection laws spur faster development of financial markets.

Kwok and Tadesse (2006) analyze how national culture affects the structure of the financial system. They find that banks play a predominant role especially in countries characterized by higher uncertainty avoidance. Aggarwal and Goodell (2009, 2010) find that bank financing is stronger compared to market financing in countries with a lower control of corruption, lower efficiency of debt enforcement, and lower political stability, but greater political legitimacy.

Looking at these papers, relationship banking can be seen as a substitute for financial markets especially in weak economic environments, where relationships are need as substitutes for

contracts. Next, we examine whether relationship banking can address some social challenges and contribute toward decreasing inequality and increasing innovations.

3.3. Inequality and relationship banking: local economic growth and credit for small and medium-sized firms, the poor, and minorities

A developed financial system has long been considered beneficial to economic growth (Beck, Levine, and Loayza, 2000; Ang, 2008), with relationship banks being no exception. Berger, Hasan, and Klapper (2004) point to the importance of stable, local banks—typically seen as promotors of relationship banking, as in Stein (2002) and Berger et al. (2005)—for economic growth.

Less certain is how relationship banking supports economic growth *across* regions and *across* populations. The intention here is not to detail the nexus between inequality and finance (see Bazillier and Hericourt, 2016), but to suggest the mediating role of relationship banking that has hitherto not been fully established in the literature. We propose that relationship banking can work to reduce inequality by *i*) promoting local economic growth, *ii*) financing small and medium-sized firms, *iii*) financing the poor, and *iv*) financing minorities.

First, evidence indicates that the presence of a local bank branch is important for local development. Small, local banks fuel local economic growth, especially in less developed regions with severe credit rationing (Hakenes et al., 2014). Hasan, Koetter, and Wedow (2009) find that bank efficiency is an important determinant of local growth, especially if coupled with credit growth.[5] What can be envisaged from these findings is that banks support local growth especially if they engage in efficient financial intermediation activities. In addition to the size of lending, the quality of the banking sector matters. In this light, relationship banking supports local growth if sufficient efficiency is attained.

[5] Hasan, Wachtel, and Zhou (2009) find a flat or even negative relationship between the depth of the banking sector and local economic growth, and they attribute this to the prevalent state ownership of banks in China. Önder and Özyıldırım (2010) find that private banks better support local growth than state-owned banks, and they attribute this finding to potential inefficiencies in state-owned banks.

Relationship banking also refocuses bank clients on a long-term perspective. Burgess and Pande (2005) show that branch expansion into underdeveloped rural regions in India reduced rural poverty. The effect was driven by increased deposit-taking and credit activity of banks in rural regions, suggesting that households could accumulate more capital and obtain loans to pursue long-term productive investments.

Second, relationship banking supports societies through financing small and medium-sized firms (DeYoung et al., 2015), which typically account for the majority of firms in the economy and contribute importantly toward economic growth and employment. Bank lending to enterprises is associated with a faster reduction in income inequality compared to bank lending to households (Beck et al., 2012). For example, banks in Italy supported family firms more than non-family firms during the crisis (D'Aurizio, Oliviero, and Romano, 2015). The relative support for family firms was especially strong for banks that increased the use of soft information during the crisis. Looking at the theories of relationship banking, these findings can be related to the long-term bank–borrower relationships that encourage a long-term firm orientation.

Third, relationship banking might play a special role in light of the finding that finance improves the quality of asset allocation among the poor (Beck, Demirgüç-Kunt, and Levine, 2007). Lending from a local bank is associated with lower delinquency of mortgage loans for low-income homebuyers (Ergungor and Moulton, 2014) and consumer bankruptcy rates (Allen, Damar, and Martinez-Miera, 2016). Ergungor (2010) finds that the physical presence of a bank in low- to moderate-income neighborhoods (but not in high-income neighborhoods) is associated positively with mortgage originations and negatively with mortgage interest rate spread. This suggests that soft information is important for reducing information asymmetries, especially in poor neighborhoods, where hard data are less reliable. The role of a relationship bank may then relate to its superior ability to monitor the value of collateral or the risks of its borrowers.

Fourth, relationship banking acts as a complement to cultural, ethnic, and religious proximity and serves to lower inequality across these dimensions. The cultural proximity of a banker to borrowers reduces information asymmetries in lending. It increases quantity and quality, and it decreases the cost of lending. The benefits of cultural proximity support hard and soft information gathered through relationship banking (Fisman, Paravisini, and Vig, 2017). Albareto and Mistrulli (2011)

analyze lending to micro firms run by migrants. Their findings suggest that a bank's ability to deal with cultural diversity (e.g., opening multiethnic points, offering products tailor-made to migrant needs, etc.) might narrow the gap in the interest rates between migrant and Italian entrepreneurs.

To nurture relationship banking to its full extent, its drawbacks need to be addressed. For example, inequality may even increase if a relationship bank exploits market power over the borrowers and engages in substantial rent extraction, holding up the borrower, as in Rajan (1992). In such cases, especially if it is opaque and unable to allocate resources optimally, the banking sector can be associated with higher inequality (Gimet and Lagoarde-Segot, 2011). The typical response to mitigate the hold-up problem is to increase competition in banking. Delis, Hasan, and Kazakis (2013) corroborate that financial liberalization of the banking system decreases income inequality.

Therefore, to enhance the benefits of relationship banking and mitigate the downside, customer protection legislation should prevent abuse of financially uneducated customers by financial players. Higher longevity and larger volatility of income and spending needs of bank customers through their lifecycles fuel increased financing needs of the population. Older and younger adults are more prone to financial mistakes than middle-aged adults (Agarwal et al., 2009) and more exposed to unfair lending practices such as excessive fees or even predatory lending (Agarwal et al., 2014; Agarwal, Ben-David, and Yao, 2017).

What this shows is that relationships and proximity matter in banking. Banks that are geographically and culturally closer to their borrowers make better lending decisions, lowering financial exclusion of minorities and fragile groups, and reducing inequality within society. For this to occur, the banker needs to have sufficient flexibility and discretion to incorporate cultural knowledge into decision-making.

3.4. Can relationship banking facilitate innovation?

Historically, bank credit was perceived as a hindrance to innovative firm behavior. The reasoning was that banks prefer lending to stable companies, whereas investments in innovations are inherently risky. In this light, Black and Strahan (2002) find that the presence of small banks is negatively related to the formation of new firms, with a negative impact on entrepreneurship.

Recently, this notion has been somewhat reversed, with relationship banking perceived as a promotor of innovation. Relationship banking, the thinking goes, lowers information asymmetry and thereby spurs funding of small firms and their innovative projects. Hombert and Matray (2017) find that a shock to relationship lending lowers the number of innovative firms (i.e., the firms that file patents) and induces innovators to move out of geographical regions where lending relationships are damaged. Alessandrini, Presbitero, and Zazzaro (2009) argue that bank functional form is related to the innovativeness of bank-dependent borrowers. Non-hierarchical and small banks—typical relationship-oriented banks—are associated with higher support for innovations of their borrowers. Benfratello, Schiantarelli, and Sembenelli (2008) provide evidence that local banking development especially supports process innovation rather than product innovation.

How can one reconcile the findings that relationship banking is associated with higher innovation activity but also with lower entry of new firms? The first explanation, provided by Hombert and Matray (2017), claims that lower new firm entry does not preclude higher innovation because only a few new firms innovate. A second explanation posits that the quality rather than the form of bank financing matters for new venture formation (Hasan et al., 2017).

A potential third explanation states that the long-term orientation of relationship banking facilitates investment in innovation. To secure funding, firms are willing to trust their relationship lender with sensitive information about their innovative activities. Relationship banking may then act as a resistance to short-termism driven by financial markets or by arm's-length transaction banking, responding to Lazonick and Mazzucato's (2013) call for a fairer division of returns on innovation.

In this light, financial innovations might potentially be less benign. Boot (2011, 2014) argues that greater marketability in banking may lead to "footloose corporations" that are driven by opportunistic behavior, with repercussions for stability. Relationship banks seem to resist such short-termism better.[6] Financial innovations made inroads into banking especially through large

[6] An example is the process of securitization, in which banks granted mortgages, bundled and sliced them, and sold them off (rather than keep them on the balance sheets). Online distribution channels of mortgage applications and transaction lending techniques that hardened information about loan applications facilitated the securitization process. Several authors see disintermediation as one of the culprits for the subprime mortgage crisis (Mian and Sufi, 2009; Keys et al., 2010).

and new banks, but less through relationship-oriented banks, for which the benefits of financial innovations were the most limited (Zarutskie, 2013).

Altogether, relationship banking spurs local economic growth and facilitates the financing of small and medium-sized firms, the poor, and minorities. It supports firm innovations and counters the short-termism of financial markets, providing long-term incentives for stability. A core advantage of relationship banking lies in its long-term orientation and pronounced flexibility and discretion, which support the acquisition of soft information and decision-making based on soft information. What this largely shows is that the economic benefits of relationship banking may be rather sizeable. We continue by discussing potential drawbacks and challenges of relationship banking.

4. Relationship banking during the financial crisis and its aftermath

This section discusses whether relationship banking has amplified or attenuated the financial and economic crisis. It analyzes how relationship banking is affected by the government or regulatory intervention to shore up a weak banking system. The role of bank regulation is reviewed.

4.1. Is relationship banking beneficial during crisis times?

A well-confirmed empirical regularity is that financial difficulties of a bank are propagated further to the bank's borrowers. If a bank is struck by a sudden solvency or liquidity shock,[7] its borrowers suffer valuation losses, receive less credit under less favorable lending terms, reduce employment, and shrink their exports more compared to borrowers from unaffected banks (Chava and Purnanandam, 2011; Khwaja and Mian, 2008; Amiti and Weinstein, 2011; Chodorow-Reich, 2014). The negative effect is mostly limited to small, opaque, and bank-dependent borrowers. Large, transparent borrowers can overcome most of the financing problems by reaching out to

[7] For example, Chava and Purnanandam (2011) use the Russian crisis of fall 1998 as an exogenous shock to the US banking system. Khwaja and Mian (2008) analyze the liquidity shocks induced by unanticipated nuclear tests in 1998 in Pakistan.

unaffected banks or by tapping public markets. Even if a shock is limited to a single bank, it can still adversely affect aggregate lending and the real economy (Amiti and Weinstein, 2018).

In recessions, loan spreads rise especially for firms without access to public debt markets (Santos and Winton, 2008). Santos (2010) focuses on the US subprime loan crisis, where banks were hit by the collapse of the subprime mortgage market. Banks that incurred larger losses increased loan spreads on their loans by more than other banks. This effect only occurred in the case of bank-dependent borrowers, but not in the case of borrowers with access to public debt markets.

The finding that bank-dependent borrowers are the most affected during the financial crisis is consistent with ex-ante and ex-post screening-based relationship banking theories, which argue that a bank that gathers proprietary information can hold up its borrowers and use an information monopoly to extract additional rents (Sharp, 1990; Rajan, 1992; Ioannidou and Ongena, 2010). These theories posit that the hold-up problem is especially severe for bank-dependent, small, and opaque borrowers and during financial crises, when information problems are most acute. Banks, so these theories claim, use relationship banking mainly to extract rents from their borrowers. In this view, relationship banking has a dark side.

However, several articles support an alternative—more positive—view of the role of relationship banking during crises (Beck et al., 2018; Bolton et al., 2016; Iyer et al., 2013). Beck et al. (2018) find that banks engaged in relationship lending cut back on lending during a financial crisis less than banks engaged predominantly in transaction lending. This finding is the strongest for small and opaque firms and does not stem from rolling over underperforming loans.[8]

How can one reconcile these (at first sight) contradictory results? First, Bolton et al. (2016) allow for multiple banking relationships, where, arguably, the market power of a bank is diluted and the hold-up problem is less severe (see also Detragiache, Garella, and Guiso, 2000; Gopalan, Udell,

[8] Schiantarelli, Stacchini, and Strahan (2016) show that bank borrowers strategically halt their loan repayments, as predicted by Trautmann and Vlahu (2013), if they anticipate a failure of their bank. A strategic default is the weakest for small borrowers, who have limited bargaining power over their bank.

and Yerramilli, 2011).[9] They show that relationship banks provide more favorable continuation of lending during a crisis.

Second, articles that posit that a crisis propagates from a bank to its borrowers typically do not account for different bank lending technologies. If a bank employs transaction lending even for smaller, more opaque borrowers, then the finding that these borrowers are hurt in a crisis does not necessarily make relationship lending culpable. Exceptions are Beck et al. (2018), Iyer et al. (2013), and Young et al. (2015), who account for the strength of bank–borrower relationships and the strategic orientation of a bank. Borrowers with stronger banking relationships are more likely to secure the continuation of lending in a crisis than borrowers with weak banking relationships (Iyer et al., 2013).[10] US community banks that strategically focused on granting illiquid commercial loans even increased lending to small and medium-sized firms during 2008 (Young et al., 2015). This evidence is consistent with the interpretation that a strategic orientation toward relationship banking cushions a credit supply shock to small and medium-sized firms.

Third, relationships with bank depositors are also important in a crisis. Borrowers that have a long-term deposit relationship with a bank are more often able to secure the continuation of lending in a crisis (Puri, Rocholl, and Steffen, 2011). Berlin and Mester (1999) show that core deposits allow banks to insulate borrowers from exogenous shocks to interest rates. Depositors with long-term relationships with a bank are less likely to run in the case of bank trouble (Iyer, Puri, and Ryan, 2016). Depositors with frequent past transactions run more. Depositors that also borrow from the bank or depositors that are also bank employees are less likely to run in the case of a low-solvency risk shock but are more likely to run in the case of a high-solvency risk shock.

Fourth, Banerjee, Gambacorta, and Sette (2017) point to the difference between an external shock to the banking system and a systemic shock to both the banking system and the economy. Whereas Italian banks were able to insulate their lending relationships from the shock endured by the

[9] Rent extraction of the main bank can also be mitigated by access to capital markets or to venture capital funding (Berger and Schaeck, 2011).
[10] However, Carvalho, Ferreira, and Matos (2015) reach the opposite conclusion. Further research on this topic is thus warranted.

Lehman default, the lending relationship benefits were eroded during the European sovereign debt crisis. Further research may highlight whether the role of relationship banking changes if a crisis is liquidity-driven or solvency-driven, or if it is driven by an exogenous shock to a bank or by a shock to the bank's borrowers.

4.2. Relationship banking and bank bailouts

During the global financial crisis, governments acted to prop up their weak banking systems through large government support programs. The literature confirms that government support to weak banks translates into better lending terms for their borrowers and helps shore up the real economy. It is less clear, however, whether government support enhances relationship banking.

Norden, Roosenboom, and Wang (2013) show that government infusion of capital into weak banks was associated with a positive impact on borrowers' stock returns, and this positive impact was more pronounced for bank-dependent firms. Local banks in Argentina responded with a cumulative lending expansion of $1.20 per additional dollar of external finance (Paravisini, 2008). Berger, Makaew, and Roman (2018) analyze the US government infusion of capital into banks through the Troubled Asset Relief program. They show that government support to banks improved lending terms for both relationship and non-relationship borrowers, with a slightly higher improvement for non-relationship borrowers.

It is important that capital injections into weak banks are large enough to support continuous lending and consequent investment of firms (Giannetti and Simonov, 2013). If capital injections are small, banks continue to fail and might engage in rolling over nonperforming loans to prevent further regulatory interference (Homar and Wijnbergen, 2017). The conclusion from these papers is that capital infusion should be sufficiently high to allow for the successful restructuring of failed borrowers and to prevent a soft budget constraint problem in which borrowers could extort their bank due to its weak financial position.

4.3. The changed regulatory framework and its impact on relationship banking

Following the global financial crisis, the bank regulatory and supervisory framework experienced a major overhaul that resulted in higher levels and quality of bank capital, liquidity regulation, and structural changes. The question still largely left to be answered is how changes in regulations will affect relationship banking. Bolton et al. (2016) confirm the theoretical prediction by Morisson and White (2005) and Allen, Carletti, and Marquez (2010) that banks with higher capital would engage in more intensive monitoring, this being a characteristic of relationship banking (Repullo and Suarez, 2012). In this light, Basel III capital requirements could work to enhance the attractiveness of relationship banking in the long run. However, implementation is important, and capital requirements should be increased gradually and in good times to prevent a shock to bank lending (Jiménez et al., 2017).

It is even less understood whether liquidity regulation is related to relationship banking. Duijm and Wierts (2016) and Bonner and Eijffinger (2015) find little effect of liquidity requirements on bank lending to corporates, but they confirm that liquidity requirements affect the structure of bank liabilities. Hence, liquidity regulation can affect the amount of funding that banks obtain from core relationship deposits.

A related question is the connection between structural bank regulation and bank engagement in relationship banking. Here we note that combining relationship banking with other risky banking activities may lead to dis-synergies. For example, if bank operations on a financial market such as trading become large, banks cannot commit their resources to relationship banking ex-post, which suppresses their ability to build relationships ex-ante (Boot and Ratnovski, 2016). Huang and Ratnovski (2011) suggest that wholesale funding can be disruptive and can spur excessive liquidation. Both studies argue that relationship banking needs to be insulated from destabilizing forces on financial markets that come from either short-term funding or trading.

Overall, relationship banking can work as an anchor of stability for the economy during crisis times if it successfully overcomes the hold-up problem. The revised regulatory framework provides further support for relationship banking. In a crisis, the strains between political forces and relationship banking intensify. Although in crisis times banks might need state support to shore

up stability, it is important to preserve the competitive landscape in banking. However, political actors might have more sinister motives during their involvement in banking. We address this topic in the following section.

5. Political forces and relationship banking

Relationship banking faces pronounced challenges due to the changing political landscape, where political interference, borders, and (lower) competition might gain prominence.

5.1. Political interference: Government ownership and organizational form

A large body of literature documents that political interference distorts the allocation of funds (Brown and Dinç, 2005; Dinç, 2005; Carvalho, 2014). Political interference in banking may be manifested through several channels. First, government interventions to secure stability in banking are based on political calculations. For example, politicians postpone government interventions into failing banks in election years, fearing a backlash from the electorate (Brown and Dinç, 2005). Second, politicians can favor one group of banks over another (e.g., state-owned banks vs. private banks or domestic banks vs. foreign banks). Foreign banks may even be subjected to direct or indirect expropriation by the host government; for example, through high taxes or requirements to hold government debt (Dell'Ariccia and Marquez, 2010). Third, politicians use government ownership to exert influence over lending decisions. Government ownership is associated with less developed financial systems and interventionist and inefficient governments (La Porta, Lopez-De-Silanes, and Shleifer, 2002). State-owned banks increase lending in election years (Dinç, 2005) and lend favorably both to politically connected firms (Khwaja and Mian, 2005) and in politically important regions (Sapienza, 2004). Politicians impact bank lending policies to reap private benefits (Chen, Hasan, Lin, and Yen, 2015), such as influencing firms to move employment to politically important regions (Carvalho, 2014).

The drawback of relationship banking lies in its pronounced vulnerability to political interference. The core advantage of relationship banking stems from soft information acquisition and from decision-making based on soft information, for which a relationship banker needs a substantial level of discretion and flexibility. Although discretion is considered an advantage in alleviating

information asymmetry, it opens a back door for political interference with bank operations. Infante and Piazza (2014) confirm that political influence over bank lending is especially strong if local loan officers are granted high autonomy in their decision-making.

It is less clear whether a causal relationship exists between a relationship banking orientation and government ownership. A potential explanation could be that state-owned banks abuse relationship banking because discretional decision-making on the basis of soft information allows for unbridled political interference. An alternative explanation could posit that state-owned banks simply employ relationship banking because, as domestically-centered banks, they are the closest to the firms and have the greatest access to soft information. Whereas domestic banks rely on relationship lending to exploit their preferential access to soft information, foreign banks use transaction lending techniques to overcome informational disadvantages (Beck et al., 2011; Beck, Ioannidou, and Schäfer, 2018; Berger et al., 2008).

Dell'Ariccia and Marquez (2010) analyze whether banks enter new markets by opening a subsidiary (a separate legal entity protected by limited liability at the subsidiary level) or a branch (merely an office without a separate legal standing). If foreign banks are exposed to the political risk of expropriation by host governments, they enter through a branch. However, a branch can only support bank operations on a limited scale, and this precludes the deep presence necessary for relationship banking (Cerutti, Dell'Ariccia, and Martínez Pería, 2007).

Relationship banks may try to contain political interference by changing their organizational structure. A more hierarchical and centralized organizational structure functions better in an environment pervaded with corruption (Skrastins and Vig, 2019). It also lowers rent extraction (Canales and Nanda, 2012). However, higher hierarchy and centralization may adversely affect decision-making based on soft information crucial for relationship banking (Berger et al., 2005; Stein, 2002; Liberti and Mian, 2009). It is decentralization and lower hierarchy that lead to higher production of soft information and decreased standardization of loans with subsequently improved loan quality (Skrastins and Vig, 2019). A decentralized organizational structure, in which bank branch managers are given greater autonomy over their lending decisions, spurs lending to small firms and firms with an abundance of soft information (Canales and Nanda, 2012).

To conclude, banks' response to political risks may affect the scope of relationship banking. In a sense, relationship banking has been caught between Scylla and Charybdis. On the one hand, relationship banking is most valuable in countries characterized by weak contract enforcement, high corruption, and a volatile political environment (see Section 3.2 and Aggarwal and Goodell, 2009, 2010). On the other hand, relationship banks themselves are prone to corruption and political interference. Although they can limit relationship engagement (e.g., by organizing into more hierarchical structures), that would also comprise their competitive advantage.

A potential solution to this conundrum may come in the form of bank supervision. Beck, Demirgüç-Kunt, and Levine (2006) analyze whether thorough bank supervision could lower the drawbacks of bank corruption. They find that engaging a supervisory agency to monitor and discipline banks is not effective in lowering corruption in lending. Rather, supervision that empowers private monitoring of banks (e.g., through disclosure of accurate information to the private sector) lowers the impact of corruption in banks on firms' ability to raise external funding. Countries with sound legal institutions are especially able to reap the benefits of bank regulation, which empowers private bank monitoring.

5.2. Can borders hinder relationship banking?

Interventionist government support for banks during the financial crisis modified the competitive landscape in banking (Hasan and Marinč, 2016). Changed political circumstances may affect competition, potentially reversing globalization and internationalization with further protectionist intentions. We now evaluate the role of borders for relationship banking. We envision three channels through which borders affect relationship banking.

First, higher borders might mean lower competition. A large body of literature has analyzed the connection between competition and relationship banking without reaching a definitive answer. On the one hand, Petersen and Rajan (1995) find that banks invest less in building closer relationships with their borrowers if they anticipate that future competition will render such relationships less profitable (see also Ogura, 2010). On the other hand, Boot and Thakor (2000) argue that competition erodes rents especially in transaction banking and less so in relationship banking. As a response, banks resort to relationship banking if competition intensifies. Degryse

and Ongena (2007) provide empirical evidence suggesting that bank branches employ more relationship lending in the case of higher local competition.

Several other variables may affect the relationship between competition and relationship banking. Presbitero and Zazzaro (2011) point to the role of the organizational structure. If large and distant banks are present in the credit markets, higher competition suppresses investment in relationship banking. However, if small, local banks are in the majority, higher competition pushes banks toward more relationship banking. Hasan et al. (2017) find that cooperative banks support the formation of new firms and provide financing for small and medium-sized corporations whereas large banks facilitate efficiency improvements for small and medium-sized corporations. On the basis of meta-analysis, Kysucky and Norden (2016) conclude that the benefits of relationship banking prevail over drawbacks if bank competition is high. Hence, limiting competition might result in less relationship banking and in limited benefits of relationship banking.

Second, higher borders insulate local banks from external shocks, allowing them to focus on relationship banking. Borders may prevent a financial crisis from spreading across countries. Giannetti and Laeven (2012a, 2012b) identify a flight home effect, in which international banks reduced their lending abroad more during the global financial crisis compared to lending in their domestic market. Schnabl (2012) analyzes the transmission of the 1998 Russian default to Peru. Lending to Peruvian firms decreased in the aftershock, and the effect was the most pronounced for domestically owned banks that borrow internationally, intermediate for foreign-owned banks, and weakest for locally funded banks.

Banks reduced lending less following the global financial crisis if they were heavily integrated with the local market (i.e., if they operated a subsidiary, were more experienced, and were integrated with the network of local lenders) and if they lent to geographically close borrowers (De Haas and Van Horen, 2012; De Haas and Lelyveld, 2014). What this suggests is that banks strengthen their stability if they establish a strong foothold in local markets that encompasses relationships in lending and local funding (e.g., local deposit-taking).

Third, borders further hinder information transmission across multinational banks that already have larger problems in gathering and transacting soft information across their hierarchical

organizational structures (Berger et al., 2005; Stein, 2002). If borders are strengthened, subsidiaries of distant banks might further be challenged to engage in relationship banking.

In addition to borders along national lines, cultural, religious, and ethnic lines might create new barriers for relationship banking. Multinational banks with branches at greater geographical and cultural distances from their main headquarters shy away from relationship lending (Mian, 2006). Thus, higher frictions within the society exacerbate information problems in lending, which banks need to adjust to.

Alongside gathering idiosyncratic knowledge about certain borrowers, banks also collect market-specific knowledge about foreign markets. Paravisini, Rapporport, and Schnabl (2017) find that exporters borrow from banks that have specialized for their export market. If borders curtail globalization and international trade, bank knowledge about export markets may lose its value.

Whereas a substantial body of literature analyzes the *removal* of geographic restrictions,[11] there is little evidence about what happens when countries *strengthen* their borders. The caveat of this reasoning that derives from the current literature is that it is assumed that strengthening borders yields reversed effects compared to opening borders. Dynamics may play a role here, and the consequence of closing borders might be thoroughly different.

In brief, political developments might curtail the benefits of relationship banking. How to make relationship banking robust to withstand political interference, the changing competitive landscape, and potential new borders is an important avenue for further research.

6. Conclusions

This article provides a review of how relationship banking can adjust to the changing economic and political environment. We argue that relationship banks are well suited to tackle long-term economic challenges. First, relationship banking supports local economic growth and increases

[11] Rice and Strahan (2010) analyze how the removal of geographic restrictions on bank expansion affects small firms' financing. They find that small firms borrow at lower interest rates, whereas the amount that small firms borrow is left unchanged.

financing of small and medium-sized firms, the poor, and minorities, all working to reduce inequality in society. Pressure on relationship banks in the form of interbank competition and customer protection is needed to constrain rent-seeking behavior. Second, through a reduction of information asymmetries, relationship banking facilitates the financing of firms that pursue innovative activities. A long-term orientation of relationship banks—which acts in sharp contrast to the short-termism of financial markets—facilitates innovations that bear fruit on a long-term basis.

However, relationship banking needs to respond to short-term economic challenges such as financial crises, government interventions, and the revised regulatory framework. Whereas substantial empirical evidence suggests that relationship banks aim to support their borrowing relationships during a crisis, studies also show that a shock to such a bank is transmitted to its borrowers, and the impact is the highest for weak borrowers. For the positive effect of relationships on stability to prevail, it is crucial to make relationship banks more resilient. In this light, raised levels of capital as demanded by Basel III support the benefits of relationship banking.

We highlight the drawback of relationship banking that relates to political interference. To act upon unverifiable soft information, bankers need to be granted discretionary powers in lending. However, discretion allows for manipulation by politicians that seek power over bank lending. Protectionist political forces that result in lower competition and tighter borders might place further strains on relationship banking, especially within large, multinational banks.

The world has become a less predictable place. We envision long-term–oriented relationship banking as an anchor of stability that surpasses the notion of weathering financial and economic crises and extends into political and social changes. Relationship banks should then actively shape societies toward common long-term goals. The difficulty of defining such goals should not deter researchers and banks from tackling this important question.

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