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EDITORIAL OVERVIEW

Relationship Banking

This special issue on relationship banking is the outcome of a number of good papers on this topic being submitted to the *JFI* over the last two years. Although we did not have an event like a conference to bring these papers together, collectively these papers paint a coherent picture of emerging thoughts and questions in this area that I hope will inspire more exciting research in the future.

The paper by Arnoud Boot, "Relationship Banking: What Do We Know?," is a succinct review of the major themes in this area, and it sets the stage for the rest of this issue. Boot places relationship banking within the context of the contemporary financial intermediation literature and points out that relationship-banking services, as portrayed in the current literature, could hardly be viewed as being unique to banking. He thus considers *relationship intermediation* a more appropriate label for this research. Boot's paper examines both the costs and benefits of relationship banking. The costs include the "lock-in" effect of relationships due to the acquisition of proprietary borrower-specific information by the bank over the duration of the relationship, as well as renegotiability issues with the "soft-budget" constraint and the attendant incentive distortions. The benefits include the ability to improve the economic efficiency of credit contracts over the duration of a long-term relationship. This is achieved through a reduction in welfare-dissipating collateral as well as through the deployment of welfare-enhancing intertemporal tax–subsidy schemes in loan pricing.

An interesting aspect of Boot's review is that he explicitly considers the effects of competition on relationship banking. His conclusion is that the effect is not as clear-cut as previously thought and that competition could diminish the *level* of relationship banking while increasing its *quality*. Boot also considers various empirical implications of the theories, and discusses the key empirical work done so far.

An open question emerging from the theory is how many bank relationships a borrower should have. The prediction seems to be: as few as possible to prevent the borrower from "locked in." However, our understanding of the precise determinants of the number of bank relationships, as well as of possible cross-country variations, is quite primitive. On this score, the Ongena and Smith paper, "What Determines

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the Number of Bank Relationships? Cross-Country Evidence," in this issue makes a very valuable contribution. It examines a European data set of over a thousand firms. The authors find large variations in the average number of bank relationships per firm. The most interesting finding is that firms maintain more relationships with banks in countries where creditor rights are relatively poorly enforced, as well as in countries with fragmented but stable banking systems and active public bond markets.

These empirical findings have to be interpreted in the context of the incentives of banks to monitor the borrower when there are multiple lenders involved in extending credit to the borrower. These incentives are affected by the seniority of the bank's claim relative to other creditors. There is a puzzle on this count, however. The modern theory of financial intermediation views banks as monitoring experts, and generally speaking junior lenders have the strongest incentives to monitor the borrower at a cost. So why is it that small-business bank loans are typically the most senior?

Longhofer and Santos, in their paper "Relationship Lending Within a Bank-Based System: Evidence from European Small Business Data" in this issue, address this question theoretically. Their insight is that seniority provides the bank with the strongest incentives to build a *relationship* with the firm. The idea is as follows. Once the firm's financial condition has deteriorated, junior creditors have the same weak incentives to invest additional resources in the firm as shareholders do. The strongest incentives for making additional investments rest with the senior creditors. If the bank is made junior to the other creditors, they benefit little from additional investments in the firm during times of poor performance and thus will have little incentive to build relationship.

Given that a bank loan is senior because it provides incentives to build relationships, there are important questions about the optimal *duration* and scope of the relationship. Theory provides some guidance on the score, but I suspect the largest payoffs are going to come from empirical research. The Degryse and van Cayseele paper in this issue, "The Importance of Bank Seniority for Relationship Lending," provides valuable evidence. It investigates duration and scope for various price and nonprice terms of the loan contract. The main findings are that the loan rate increases with the duration of the relationship, suggesting the existence of a "lock-in" problem, and that an increase in the scope of the relationship decreases the loan interest rate. An ancillary finding of interest is that the collateral requirement declines with relationship duration and increases with relationship scope.

I believe that our understanding of relationship banking has advanced significantly as a result of the papers collected in this issue. Important questions remain unanswered, however. Foremost among them is an improved understanding of *how* relationship banking will evolve as intermediation itself undergoes metamorphosis in the new economy in which the marginal cost of information is approximately zero and the ratio of private to public information is declining rapidly, perhaps approaching an asymptote at which our existing notions of why financial intermediaries such as banks exist become meaningless.

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