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Does Relationship Banking Have Value for Small Firms?

While the potential benefits of relation-ship banking have been given increasing attention in the finance literature, the European capital markets are simultaneously at least to some extent moving towards a more market based system. Even if the bond market may be the most efficient way to finance the very largest corporations, there is little evidence to indicate that it would be profitable for other firms to bypass banks or long-term bank-borrower relationships in a traditionally bank based financial system. This study is the first one to investigate empirically the importance of bank-borrower relationships for small and medium-sized firms in the Finnish capital markets.

This study examines empirically the effect of bank-borrower relationships on the availability of funds, cost of funds and loan collateral requirements in a sample of small and medium-sized Finnish firms. We use three different measures for the closeness of the bank-borrower relationship. These measures are the number of banks the firm borrows from, the length of the relationship between the borrowing firm and its main bank and whether the loan has been taken form the firms main bank or some other bank.

The results on loan availability suggest that a close banking relationship improves loan availability. The results also suggest that outside funding is more easily available the larger, more profitable and liquid the firm is. The results on how relationships affect the cost of funds are somewhat weaker than the ones for loan availability. It seems that small firms benefit from having long term relationships in the form of lower interest rates. This pattern is reversed for larger firms, and they do in fact pay higher interest rates when their banking relationship ages. This result is well in line with theoretical arguments on the role of bank-borrower relationships stating that smaller firms with few other options benefit from close relationships. The above theories also suggest that larger firms which for some reason borrow from banks face higher interest rates than they would if they used direct market sources. The results also suggest that the more profitable and the less levered a firm is, the less it pays for its loans.

Even if the bulk of corporate loans are secured, empirical studies on the role of collateral are few in number. Our results suggest that collateral is required more often if the firm borrows from multiple banks. This result is intuitively appealing because it can be easily accepted that a bank will be more inclined to require collateral as security, if it is likely that the firm will borrow from other sources as well. The results also suggest that large firms pledge less collateral. We also investigate the effect that interbank competition has on loan availability, cost of funds and collateral requirements. The results suggest that while interbank competition has no impact on loan availability or the cost of funds, the number of banks that operate locally does seem to reduce collateral requirements.

Finally the findings of this study could have some broader implications concerning the ongoing discussion around the Finnish banking environment. It has been argued that relationship banking may help limit the so-called decline in banking, which is expected to follow from securitization and non-bank competition that reduce the share of loans held by banks. The findings of this study support the above argument in that firms with bank relationships are better off because they obtain funds easier and at better terms than the firms which do not rely on relationships.