Comment on Angelini, Di Salvo and Ferri

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I commend Angelini, Di Salvo and Ferri for bringing new data to bear on the contentious issue of whether longer bank relationships lower or raise the cost of credit for borrowers. As the authors point out, the theoretical literature on this question is sharply divided and empirical work is needed to determine which class of models better describes the data. I expect that scholars working on this topic will find the paper to be an important contribution. In my comments I will try to both anticipate what skeptics will say about this paper and then make some suggestions for next steps.

I anticipate that most of the debate over this paper will center on the data. The data on credit relationships is much richer than what has been used by others. Because one can actually get a large sample of small firms and information on how long they have been borrowing, it would appear that findings in this paper should be decisive. However, the credit relationships data is merged with information from an ad hoc survey. So the full analysis relies on both sources of data.

If one wants to attack the findings, the place to push is on the selection effects that are generated from merging the two data sets. The 1858 firms in this study have an average of 10 employees and have been in business for about 19 years. This means that the typical firm has survived both the early 1980s recession and the 1992/93 recession. These are obviously atypical small firms.

One possible explanation (briefly discussed by the authors) for their key finding, that lending rates rise with the length of the relationship, is that most
of these firms have opted for the “quiet life”. Under this view, the fact that the firms have not matured and moved on to more sophisticated financing arrangements is a signal that they are under-performing. This explanation implies that it is not possible to learn about the importance of improved information flow over time because this effect is overwhelmed by the selection effect.

The authors mostly dismiss this explanation because they contend that it cannot explain why the members of the credit cooperatives see their rates fall while other customers of the cooperatives have rising rates. It seems plausible that one of the features of the cooperative organizations might be to help smaller aggressive firms distinguish themselves from the firms seeking the quiet life – this is essentially the peer monitoring hypothesis. In this case, the two selection effects can explain all of the different correlations between interest rates and length of relationships. Furthermore, one could argue that the selection effects could be masking the impact of banks getting better information about their customers over time.

Summing up, I believe that the authors have come up with some provocative information that will add fuel to the debate over whether bank capture theories or improving information models better describe the world. In fairness to the authors, this is only one of their main findings (e.g. the interesting results about how the firms survey responses regarding liquidity needs correlate with a range of attributes). However, I believe the support for the bank capture theory is what most readers will take away from the paper. Unfortunately, I also suspect that data concerns will prevent the people who strongly believe that banks are organizations which serve their customers by helping eliminate information asymmetries from changing their mind. Thus, I hope that the authors will continue to work on this topic.

One obvious next direction would be to use the panel aspect of the credit register to conduct different tests. The current paper is forced to rely on cross-firm comparisons to determine the impact of longer relationships on interest rates. If one abandoned using the survey then the authors could use time series information on firms’ own borrowing history to conduct tests. A time series study could also look at which firms move in and out of the credit cooperatives to see whether the hypothesized differences between the members of the credit cooperatives are borne out in the data.

I understand that credit register type information on the terms of bank lending for large numbers of firms are also available in other European countries including France. To the extent the bank relationship data can be connected to information on the banks customers, such as balance sheets and income statements, there are a whole range of other questions which can investigated.

One of these topics is the role of banks in the transmission of monetary policy. With the impending European Monetary Union (EMU) monetary policy throughout Europe will become more synchronized. Yet, Kashyap and Stein (1997) show that there are still wide differences in the structure and health of
the banking sectors across Europe. For instance, in Italy there are many small banks which would have a hard time raising non-deposit finance. Moreover, many of the larger Italian banks have poor bond ratings which would make it difficult for them to raise arms-length financing. In contrast, the UK is dominated by large banks which have strong credit ratings. Given these conditions a symmetric monetary contraction in all countries would likely lead to very different loan supply responses in each country.

There are also significant cross-country differences in the degree to which firms were likely to be bank dependent for their financing. Once again the UK and Italy stand out. In Italy, non-bank financing options are limited and there are many small firms which would have trouble getting non-bank financing even if capital markets were quite developed. In the UK, large firms are more prevalent and the capital markets are relatively deep.

The combination of the differences in banking markets and differences in the reliance of firms on bank funding lead Kashyap and Stein (1997) to conclude that there are may be important bank-related distributional effects of monetary policy if the EMU goes ahead soon. Using micro data on banks and firms one could test to see how past tight money episodes have played out. In particular, one can see if regions with lots of small banks have experienced bank credit crunches. Moreover, one could check the extent to which large banks have increased lending into such areas. One suspects that past credit flows within countries are likely to be an upper bound on the size of bank transfers across countries that might be possible in the early phases of the EMU. Thus, much more informed judgements about the loan supply effects of the EMU may be possible.

Similarly, good microeconomic data on credit relationships would be of value in exploring the role of banks in assisting firms which are in financial distress. Most previous studies have had to make do with very partial information on the strength of the ties between a borrower and its lenders. Information on interest rates, along with data on the size and duration of existing credit lines for multiple lenders should greatly improve the precision of the estimates of the strength of a firm’s lending relationships. With these better measures it should be possible to significantly improve our understanding of whether bank relationships shape firms’ recovery from financial distress.

References