The Personal Side of Relationship Banking

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Impact and Policy Conference:

Evidence in Governance, Financial Inclusion, and Entrepreneurship

August 30th, 2012



Motivation

- Small businesses in developing countries face many difficulties accessing financing
    - Poor disclosure and accounting standards
    - Greater difficulty of contract enforcement
    - Lack of financial infrastructure, e.g. credit bureaus

- Relationship lending is one of the major tools of credit assessment for SMEs
    - Improved screening of borrowers
    - Use of “soft” information and loan officer discretion
    - Tool for making information verifiable

Motivation II

- But focus so far of relationship lending has been on how it improves monitoring of borrowers
    - Reduction in information asymmetry

- We look at the other direction: Does relationship lending affect the willingness of borrowers to engage in moral hazard?
    - Behavioral: Borrowers might feel less comfortable to default on a specific loan officer than an anonymous bank
    - Rational: Protect future benefits from relationship with loan officer

Question

- Do SME borrowers show a difference in their interaction with the bank if they get more personalized attention?
    - Reduction in late payments or defaults
    - Appreciation and loyalty by the clients

- How to make these models sustainable?
    - Personalized attention to SMEs is expensive since loan size and margins are low but loan officer time is expensive
    - Can technology provide cheaper ways of building relationships e.g. phone and SMS?

Literature

- Focus on first dimension: Better screening of borrowers
  - Rajan (1992), Petersen and Rajan (1994), Stein (2005)
  - Berger and Udell (1995), Cole (1998), Petersen (1999)
  - Fishman et al (2011), Banerjee et al (2010)

- Organizational structure of banks and relationship banking
  - Nakamura (1994), Berger, Kashyap and Scalise (1995), Peek and Rosengren (1998), Berger et al (1998)

- Role of prior relationship in repayment behavior
  - Puri et al. (2012) and Drexler and Schoar (2012)

Set up: Small Business Loan Facility of ICICI Bank

Challenge: Moral hazard versus information asymmetry

Set up

- Only uncollateralized lending facility to SMEs in India at the time
  - Credit assessment is based on a score card approach
  - Centralized risk team makes credit decisions based on observable information, e.g. tax filing, bank statements

- Loans are structured as a one year overdraft facility
  - Payment modality like a credit card: monthly interest payments and 5% of balance has to be paid
  - Loan size between $10K-$50K
  - Penalty interest rate starts after 30 days late

Experimental Design

Group A: Personal touch treatment
Assign individual relationship manager who calls every two weeks to create "ongoing relationship" with client.

Group B: Medium touch treatment
Assign a random relationship manages to follow up with clients. Parallel to treatment A only the person changes each time

Group C: Reminder treatment
Send SMS with interest and principal due every month. Only follow up with phone call if clients have outstanding balances.

Group D: No monitoring treatment
Control Group

Implementation of the Experiment I

- Hired relationship managers to follow up with clients in treatment groups A and B
  - Very clear separation from credit assessment team
  - Convey to borrowers that relationship managers will not be involved in loan renewal

- Relationship managers have scripts to reach out to client
  - Check in every two weeks independent of loan status and payment behavior. Solve problems with accounts, remind customers of delays in payment if necessary etc
  - No cross selling (!)

Implementation of the Experiment II

- Loan applicants to SBL facility were randomized into treatment and control groups

- Total experiment period was July 2007 to April 2009

- Sample: 1319 SBA loans across all regions of India were assigned to treatment and control groups

Data and Outcome Measurement

- Data from ICICI Bank internal MIS
  - Information on overdraft usage, monthly balances, late payments (30+, 60+ or 90+ days late) etc
  - Information loan renewal and changes in loan levels
  - Ongoing information and no attrition

- Survey data: Conducted an endline survey of borrowers in treatment and control groups in April 2009
  - Data on satisfaction with bank services and detailed feedback on interaction with relationship manager

Results of Repayment Behavior

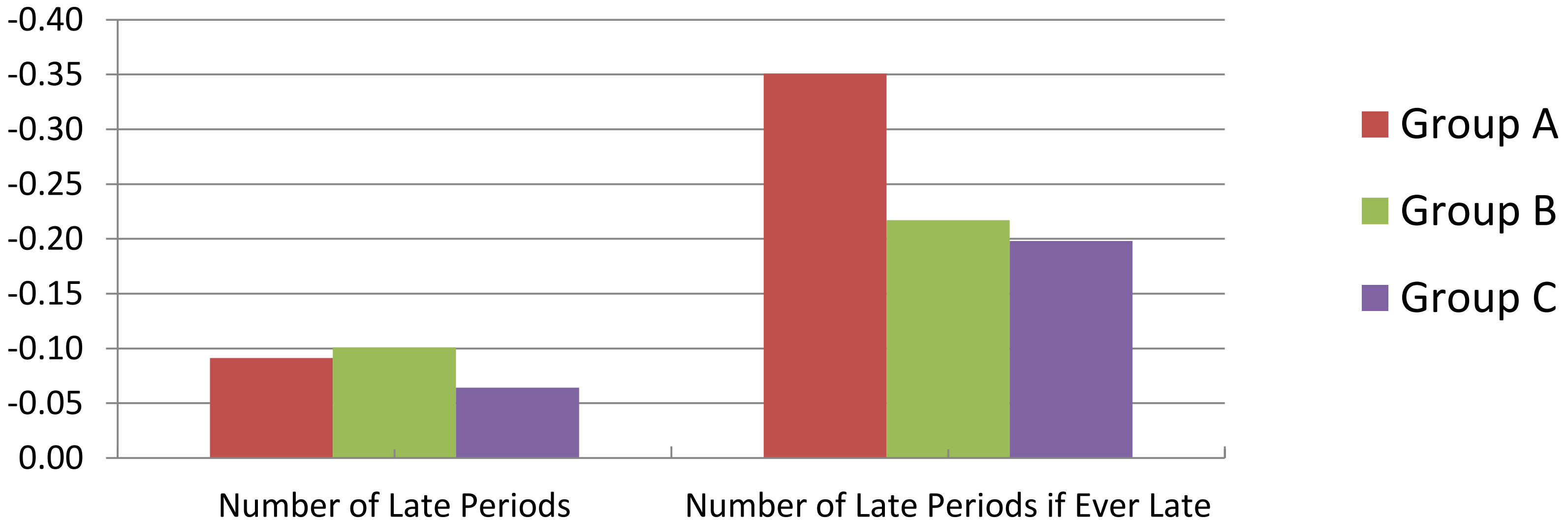
- Significant reduction in late payments for borrowers in treatment groups A and B
  - Almost 20% reduction in late payments
  - Onset of late payment and number of late payment spells are reduced for treatment groups A and B
  - Ultimate default seems to converge: Accounts in default are handled by separate department

- Improved outcomes are renewal stage for borrowers in treatment groups A and B

Delinquency Results

- The Higher Touch Treatment led to a reduction in number of accounts ever 30+ Days past due.
- The Higher Touch treatment also negatively impacted the number of multiple delinquencies.

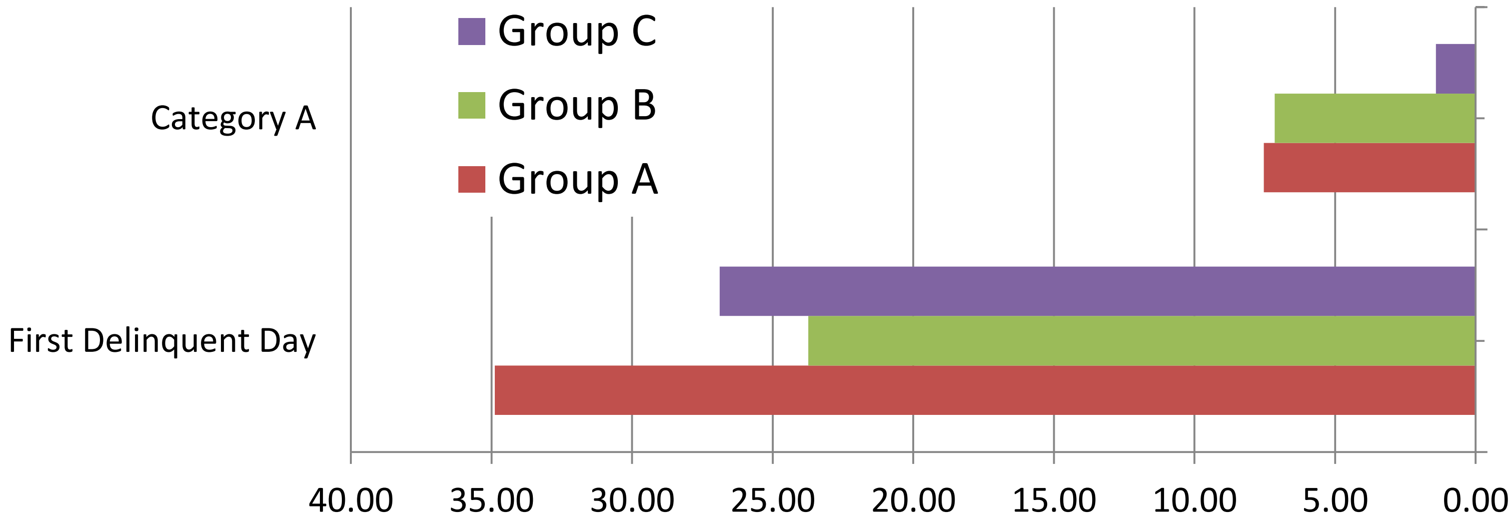
Coefficient of Treatment Dummy from OLS Regressions on Delinquency Measures



Other Results

- The Higher Touch Treatment first day of delinquency was siginficantly later compared to the control group
- The Higher Touch treatment led to an increase to a better credit categorization (Category A) at the time of renewal.

Coefficient of Treatment Dummy from OLS Regressions on Delinquency Measures



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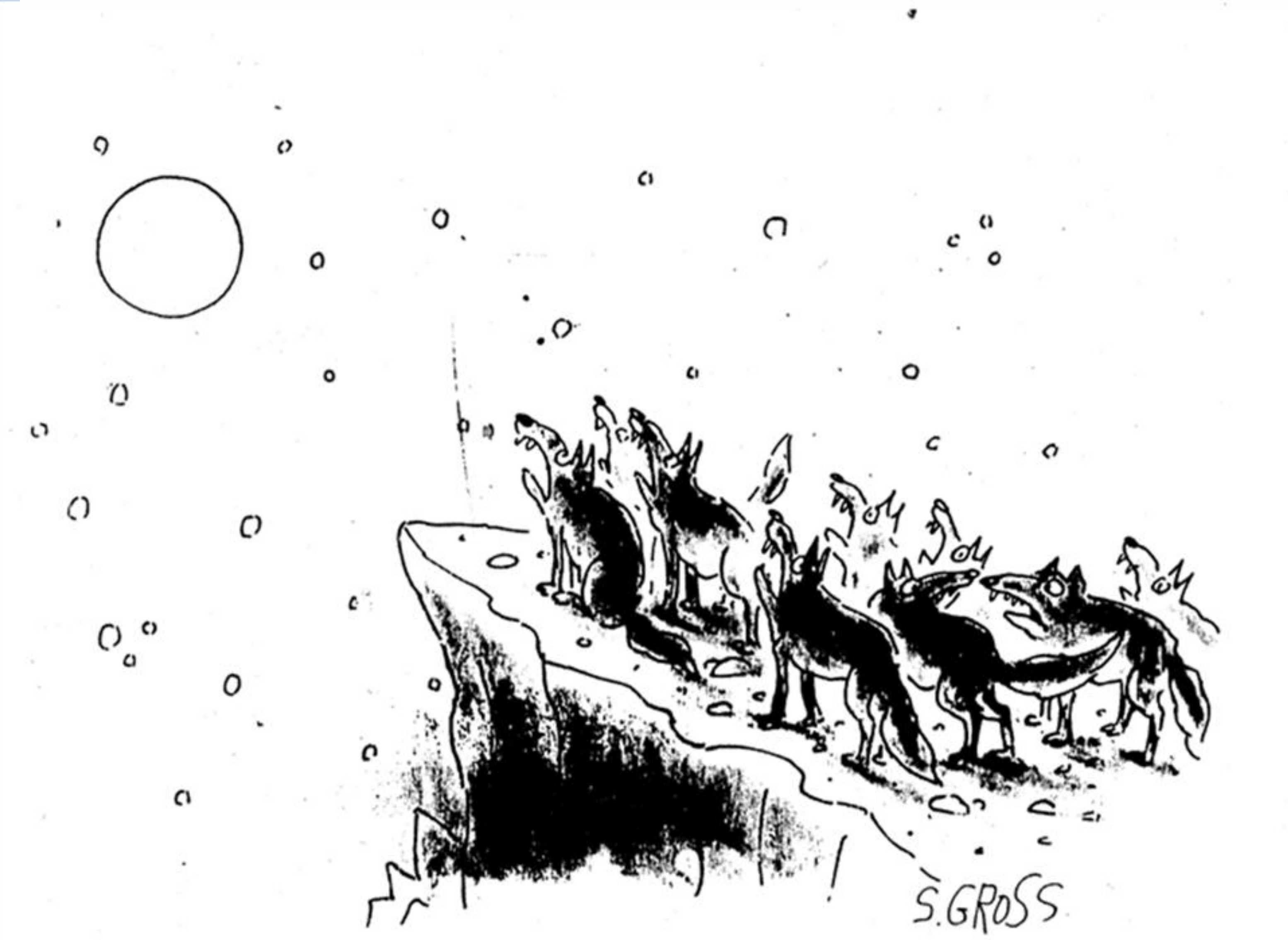
Summary

- Personalized attention by loan officers matters for repayment behavior and renewal
    - Groups A & B have significant improvement in repayment behavior
    - Relationship affects loyalty of client and their satisfaction with the bank

- Model is sustainable: Improvement in late payments outweighs the cost of tele-callers



My question is: Are we making an impact?