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Relationship Banking and Its Role in Corporate Governance

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ABSTRACT

Bank-based systems of corporate governance are certainly an alternative in many Asian economies. In spite of the great efforts directed to strengthening corporate governance along the Anglo-American model in recent years, the effectiveness of this model is far from being clear. Among other things, it requires many strong market and regulatory institutions to support it, and this is a challenging task for these economies. The bank-based model has advantages in this and other respects. Banks with a stable long-term relationship with their corporate clients are considered to have an important corporate governance role, particularly when the firms face deteriorations in their performance. This paper reviews theoretical and empirical literature on relationship banking to evaluate its advantages and risks, evaluates the constraints to fostering relationship banking in Asian economies, and presents the result of a questionnaire survey conducted in Korea's major commercial banks in order to assess the perceptions of bankers on relationship banking and bank governance.

An extensive review of the empirical literature shows that relationship banking can make a valuable contribution to the economy by allowing for the efficient monitoring of corporate borrowers, reducing information asymmetry that is an essential element of imperfection in financial markets. As a result, firms with a relationship bank tend to have easier access to credit, be less liquidity-constrained in their business activities, and receive assistance more readily from the bank when they are in financial distress. Relationship banks can play an important corporate governance role as they typically intervene in corporate management at the first signs of performance deterioration. This practice of contingent corporate governance can provide a flexible, informal alternative to the market for corporate control or bankruptcy proceedings. Relationship banking has risks as well: corporate risk-taking may be discouraged, constraining growth potential; firms may be informationally captured by their banks and pay monopoly rents; and banks may face serious conflicts of interests when their clients fall into financial distress. The empirical evidence is often mixed; this seems to a large extent to be attributable to the difficulty in defining relationship banking.

Banks in the Asian economies have been and are still considered to be constrained in terms of developing relationship banking. Given poor governance in the banks, which themselves are under the control of families or the government, connection-based lending rather than relationship banking has been prevalent. Deregulation and increased competition in the financial markets may pose a threat to relationship banking, though this is not necessarily the case once the relationship is already established or when progress is made toward a universal banking system. Relationship banking also comes under stress in times of serious financial distress for either banks or their client firms. The banks face the risks of being accused of abusing conflicts of interests or neglecting their expected obligations as relationship banks. Financial trouble and the consequent exit of a relationship bank, especially in an economy-wide crisis, is not only a fatal blow to the client firms but also a loss of the information capital held by the bank.

In the aftermath of the financial crisis, substantial changes have been made to the business environment of major commercial banks in Korea. Even though some of them have fallen under government ownership, their governance may have been actually improved and the moral hazard of their management reduced in the absence of a blind government rescue of banks and large corporations, possibly paving the way for the development of autonomous relationship banking. A questionnaire survey conducted on these banks indicates that progress has been made toward more serious monitoring of client firms and relationship banking since the financial crisis. The progress seems to have come largely from a reduction in moral hazard associated with the government bailout of banks and their large clients as well as strengthened prudential regulation and banks' own initiative for relationship management. However, the understanding and practices of relationship banking among these banks appears to be still too limited to expect any meaningful role in corporate governance to be played by them.

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1. Introduction

The term relationship banking or relationship-based banking is often used to mean connection-based banking, which constitutes the core of the "crony capitalism" that many allege brought about the Asian crisis of 1997. The crisis clearly demonstrated the potential traps of relationship banking. However, relationship banking has many advantages as well. First of all, it allows banks to make the best use of their comparative advantages versus the public debt market. Banks usually repeat transactions across different financial services, allowing economies of scale and scope in information production as well as reputation building for both parties, which can be an essential factor for loan negotiations or other financial transactions in a world of incomplete contracts. Relationship banking may be seen as nothing more than the banking practices designed to maximize these advantages.

Second, the reason why we are particularly interested in relationship banking in Asia is because of its potential role in corporate governance. Asian enterprises are predominantly family-based, even the largest business groups. Given the management control by family owners, corporate governance has typically been poor. Family owners have tended to oppose the introduction of proper corporate governance mechanisms, which would constrain their pursuance of family interests often at the expense of minority shareholders. The consequent expropriation of minority shareholders has been a serious problem, as it represents gross misallocation of corporate resources in addition to being unfair and detrimental to capital market development.

It has been widely believed that the misguided resource allocation and poor corporate investment performance were largely responsible for the Asian crisis. It is not surprising that the post-crisis reform package put high priority on improving the corporate governance system. The emphasis has been placed on strengthening the basic infrastructure for sound corporate governance, such as accounting, audit and disclosure practices. Concerning specific corporate governance mechanisms, however, the major focus has been placed on Anglo-American type systems: strengthening minority shareholder rights, improving the workings of the board of directors, and fostering the market for corporate control. Although reforms along these lines are no doubt needed, it is doubtful whether this model will work efficiently in these economies. The efficacy of the model has been much debated even in the Anglo-American countries, where the relevant capital market institutions supporting the system are relatively well established. Given the much smaller

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institutional requirement for bank-based corporate governance, it is rather surprising that the role of banks has not been much emphasized in corporate governance reform in the Asian economies.

Given the high debt leverage in corporations in the crisis-hit Asian economies and the disciplinary role of debt, banks are potentially in a strong position to monitor and control the management of client firms. In reality, however, banks have failed to play any meaningful corporate governance role in these economies due largely to poor corporate governance in the banks themselves. In Indonesia, banks were dominated by the state and private banks controlled by businesses and politicians, leading to collusion and corruption between political elite and big businesses. In Thailand, family-controlled banks were heavily involved in connected lending, even though the state and bureaucrats were less involved in the banking and big businesses. In Korea, big businesses were for the most part prohibited from owning and controlling the major banks. However, the consequent diffuse ownership structure of banks created a vacuum of corporate governance and the government continued to control and intervene in the management of the privatized banks.

As the result of recapitalization and other restructuring measures, the power of families is today much weaker in the banking sector of Thailand and Indonesia, and many countries are concerned with improving the corporate governance of banks. As the banks are reborn with adequate capital, healthy asset portfolios and sound corporate governance, they should be in a position to be more serious about relationship banking, and to avoid the many perils associated with the practice.

This paper, on the basis of a review of the theoretical and empirical literature on relationship banking, attempts to identify the main constraints to fostering healthy relationship banking, in order to enable banks to more effectively monitor their clients. Also presented is the result of a questionnaire survey of the major Korean banks to evaluate the perceptions of bank officers on relationship banking and bank governance. Section 2 describes the concept and nature of relationship banking together with its merits and demerits. Section 3 is devoted to anatomizing the empirical aspects of relationship banking, including credit availability and liquidity constraints, risk-sharing, assistance and intervention in times of corporate distress, as well as the effects on firm performance. Section 4 discusses the major constraints to banks' monitoring and disciplining of the management of corporate clients. The survey results on the perceptions of Korean bank officers on relationship banking and bank governance are presented in Section 5. Finally, Section 6 provides brief conclusions.

2. Relationship Banking: Concept and Characteristics

Relationship banking is multi-dimensional, and is maintained over cycles of corporate growth and profitability. It is also supported by various institutions that provide the concerned parties with incentives to build and foster the relationships, as is clear for Japanese main banks (MBs) and German universal banks. However, relationship banking involves both promises and perils. The desirability of relationship banking should not be taken for granted, since it ultimately depends on whether the merits can be maximized without being caught in traps.

2.1. What Is Relationship Banking?

Relationship banking may be defined as the provision of financial services by a financial intermediary on the basis of long-term investment in obtaining firm-specific information through multiple interactions with diverse financial services (Boot, 2000). Banks have advantages in gathering/producing information about their clients, thanks mainly to the nature of information production. First, there are economies of scale: the cost of information gathering/production is reduced by learning through repeated transactions. Second, there may also be economies of scope: banks can utilize the information obtained on a type of service for other services (Petersen and Rajan, 1994). Third, financial contracts are typically incomplete: banks and customers can build commitment and reputation through repeated transactions across services, often allowing the low-cost renegotiation of debt contracts (Lehmann and Neuberger, 2001). This characteristic of information production makes it natural for banks to be interested in relationship-based banking (see Box 1 for literature on bank debt and equilibrium financing pattern; see also Yoshitomi and Shirai, 2001 for a more comprehensive discussion of the inherent features of the banking system compared with those of corporate bond markets).

Intensity of relationship banking

Then, what are the operational aspects of relationship banking? What is meant by a strong relationship between a bank and its corporate clients? It is necessary to look at the duration, scope, and extent of multiple banking (Petersen and Rajan, 1994).

• *Duration of the bank-borrower relationship.* The duration is important because information is accumulated and sharpened through repeated interactions, and is largely non-transferable to those outside of the relationship. Commitment and reputation are also built and verified over time. Risk-sharing and other compensatory pricing practices often take place over the cycles of firm growth and profitability.

Box 1. Advantages and Disadvantages of Bank Debt, and Equilibrium Financing Pattern

Some of the advantages and disadvantages of relationship banking derive from the very nature of bank debt compared with public debt. Thus, it would be useful to review the merits and demerits of bank debt before dealing with relationship banking. Compared with public debt (corporate bonds), bank debt is supposed to have several advantages.

1. Bank debt is flexible (Bolton and Freixas, 2000; Rajan, 1992; Diamond, 1993). Loan covenants require the borrower to take or refrain from various actions, giving banks the right to renegotiate or call loans when covenants are violated, enhancing the flexibility and efficiency of financial contracting (Berlin and Mester, 1992; Magee and Sridhar, 1994; Park, 1994). Unlike public debt, the recontracting of existing debt is easy since the bank is a monolithic, readily accessible creditor, which is especially valuable when firms are in financial distress (Berlin and Loeys, 1988).
2. Bank debt likely reduces agency costs. Bank debt is considered to be “inside debt,” giving the debtholder access to information from an organization’s decision process that is not otherwise publicly available (Fama, 1985). Banks usually have repeated transactions with their corporate clients over many different banking services. Bank loans are typically short-term, forcing banks to make periodic evaluations of the borrower’s creditworthiness. Also, creditor banks are relatively few

(compared with bond holders), giving them stronger incentives to engage in information production and monitoring, mitigating the free-rider problem associated with public debt. Lenders may agree to divide their monitoring tasks among themselves in a way that avoids duplication of monitoring (Rajan, 1992; Diamond, 1984, 1993).

3. Creditor banks may exercise control over the investment decisions of borrowing firms. The control rights specified in loan covenants, together with efficient monitoring and better information, reduce adverse selection or moral hazard associated with external financing (Smith and Warner, 1979; Diamond, 1984; Berlin and Loeys, 1988).

The finding that a firm's announcement of a new bank loan or a loan renewal (unlike that of a bond issue) has a significantly positive effect on stock returns indicates the efficiency-enhancing role of banks (James, 1987; Lummer and McConell, 1989). Bank debt, however, does have some disadvantages compared with public debt.

1. Bank debt usually entails higher intermediation costs. These include monitoring costs, bank regulatory taxes, and the agency costs of delegated monitoring (Diamond, 1991; Berlin and Loeys, 1988). This is why more credit-worthy firms rely more heavily on public debt financing (Blackwell and Kidwell, 1988). Private debt has lower agency costs but potentially higher transaction costs given the large economies of scale in issuing public debt. Thus, firms issue public claims when the lower transaction costs of public debt offset the higher agency costs of public debt financing.

2. Control by banks may adversely affect the investment incentives of the client firms.

- Relying exclusively on short-term private debt can be costly because decisions about the roll-over or calling of the debt and liquidation will be dominated by banks (Diamond, 1993).
- Short-term bank loans (to better known firms) give little incentive to monitor the borrower, since the bank can liquidate the firm at any early sign of financial distress. Long-term debt with covenants may give banks stronger incentives to monitor (Rajan and Winton, 1995).
- More seriously, the information acquired by a bank as part of an ongoing relationship can create an "information monopoly" or hold-up problem, in that it is costly for the borrower to switch lenders (Rajan, 1992: and Sharpe, 1990). Borrowing from public markets or multiple bank relationships mitigates the hold-up problem (Rajan, 1992; Hoshi, Kashyap, and Scharfstein, 1993; and Bolton and Scharfstein, 1996).

On the basis of these characteristics of bank debt compared with public debt, many theoretical and empirical studies investigate equilibrium corporate financing patterns.

- More risky firms (with a sufficiently high demand for flexible financing) tend to use bank debt; while safer firms tend to finance from the bond market (avoiding higher cost of financing, Bolton and Freixas, 2000).
- Firms with large information asymmetries and agency costs for debt depend more on bank debt: these include smaller firms, firms with a higher proportion of intangible assets (where it is more difficult to value assets); and firms with greater growth opportunities.
- Young firms and older firms with poor performance whose ratings are too low for reputation effects to eliminate moral hazard (but high enough for monitoring to substantially reduce moral hazard) tend to use more debt (Diamond, 1991).
- Bank debt and public debt are complementary, as bank monitoring creates a public good that reduces the cost of issuing public debt (Gorton and Haubrich, 1987; Fama, 1985).

Ariga, Shima, Hutagami, and Kawaguchi (1994), looking at publicly-held Japanese corporations and banks in the 1980s, find that bank lending concentrates on companies whose default risk is high with low average stock return and high volatility. Houston and James (1996), however, find that firms with smaller size and lower leverage borrowed more among publicly-traded American firms. They also find that firms with high growth opportunities and intangible assets or with a single bank lender borrow less, indicating the substantial cost of bank information monopolies (even for larger corporations). For small firms, Petersen and Rajan (1994) find that borrowing from a single lender increases the availability of credit. Hosono (1997) finds that bank loan share to total debt had a negative relationship with R&D expenditure (as well as profitability and size), suggesting that the problem of information asymmetry is not serious for listed machinery companies in Japan. Hoshi, Kashyap, and Scharfstein (1993) find evidence of public financing being a way of insulating firms from bank monitoring: low Q, owner-managed firms are more prone to issue public debt for publicly-traded Japanese manufacturing firms.

• *Scope of the relationship*. The accuracy of information about corporate clients is increased *through* interactions in other financial services. The fixed cost of producing information about a firm can be spread over multiple products. By handling deposit accounts, the operation of settlement accounts, and foreign exchange transactions, banks acquire good information about their cash flows, liquidity situations, business partners, and the nature of their businesses. The scope is also important because the relationship (and the incentives to produce relationship-specific information) may be continued even when firms no longer rely on bank loans.

• *Extent of multiple-bank relationships.* Borrowing from a single lender, or loan concentration, is considered to represent a strong relationship banking compared with multiple-banking. This is so because the level of mutual commitment is high (smaller free-rider problem) and the scope of the relationship is also likely to be large in a single bank relationship. However, there is a risk that the firm will be informationally captured by the bank. The firm cannot easily turn to other financing sources because other potential lenders and investors have little information about it.

Relationship and stages of monitoring

Relationship financing represents an implicit commitment by banks for additional financing to liquidity-constrained or financially distressed firms contingent on their viability in expectation of various rents to the banks (Aoki and Dinç, 1997).[1] For any corporate client, relationship banking involves information production through stages of monitoring. And there are strong complementarities among these stages. Aoki (1994) argues that relational financiers tend to integrate all the stages of monitoring given the difficulties of information transfer or complementarities among the tasks in stages. Monitoring by stage includes: *ex ante monitoring* (evaluating the risk characteristics of a borrower's project before the initial financing); *interim monitoring* (watching over the borrowing firms after the initial funding to ensure that the borrowers can repay their debts); and *ex post monitoring* (closely examining the borrowing firms when they show signs of distress and working out a restructuring plan if necessary).

2.2. Incentives and Institutions in Relationship Banking

Relationship banking may be found anywhere around the world as a practice by individual banks. Even in the market-oriented system of the United States, commercial banks tend to practice relationship banking as a form of customer relations, particularly for small and medium-sized firms. Nevertheless, relationship banking is most prevalent in Germany and Japan. Banks typically serve not only as creditors but also as shareholders and are often represented on the client firms' boards of directors. German universal banks provide wide-

[1] Aoki and Dinç (1997) distinguish the rents accruing to a relationship bank by sources: *information rents* resulting from access to corporate inside information through monitoring; *monopolistic rents* coming from a financier's informational monopoly over its clients due to the non-transferability of the information; *reputational rents* derived from 'good reputation' in assisting financially distressed firms often providing costly rescue financing; *relation-specific rents* accruing to the relational financier out of the economic value created from a specific relation; and *policy-induced rents* created by the government regulation or policies usually conditional on their compliance.

ranging services including proxy voting and securities businesses, which helps them to maintain relationships with large reputable firms. Japanese MBs have been known for their commitment and reputation in delegated monitoring and extending assistances in times of financial distress.

German universal banks

German banks play an important role in corporate governance, which is oriented more toward internal than external mechanisms. Large blockholders and universal banks are central to the functioning of internal control mechanisms (Emmons and Schmid, 1998). It is likely that the most distinct features of German banks are their substantial control of corporate equity voting rights largely through proxy voting, and their representation on the supervisory boards of directors.

Proxy voting. German universal banks are rarely blockholders of corporate shares.[2] Most small shareholders designate a bank or a shareholder association to be their proxy. Universal banks have a competitive advantage in obtaining proxy voting power, as they provide the vast majority of retail brokerage services, and custodial services are needed as most equity shares are in bearer form.

Bank representation on the supervisory board. The supervisory board of German corporations is in charge of supervising management and appointing management board members. It consists of representatives of shareholders and workers in fixed proportions. Having a banker on the supervisory board may help reduce the problem of asymmetric information and lead to better credit support in times of financial distress.

There may be a conflict of interest when a bank exercises votes in its multiple roles as lender, adviser, equity holder, and voting agent (Baums and Randow, 1995). Even though German universal banks don't seem to actively compete for proxy voting, they may actually be interested in soliciting proxies for various reasons: to protect the interests of the creditor or the value of their own equity investments; or to secure a share of corporate demand for financial services.

The Japanese main bank system

Aoki, Patrick and Sheard (1994) describe the Japanese main bank system as a nexus of relationships consisting of three elements: relationship between a MB and its clients; between a MB and other creditors; and between these parties and the government.

• *Relationship between a main bank and its clients.* An MB is usually the largest lender for the client firm, providing rescue operations and dispatching directors in times of corporate financial distress. Also, the MB maintains transaction and settlement accounts of the borrowing firms and serves as the trustee of collateral or the guarantor for bond issues. Finally, it is a substantial shareholder of its corporate clients. The close bank-firm ties are depicted as a quasi-internal capital market where the MB internalizes the monitoring and control functions that are undertaken by the capital markets in the Anglo-American system

[2] The ten largest private banks held only 0.4% of the face value of corporate equity in 1994 compared with 1.3% in 1976 (Emmons and Schmid, 1998). A bank may also vote the shares held by an investment company if the bank has majority ownership. Furthermore, although many firms have restrictions on voting, they do not apply to banks' proxy voting.

(Sheard, 1989).[3] For larger firms, the MB relationship is an essential part of a broader alliance called *keiretsu*. Common membership in the Presidents' Club and significant cross-shareholding facilitate information exchanges and the coordination of decision-making as well as management oversight among affiliated firms. MB management intervention when the firm is performing poorly or in need of restructuring is regarded as an important substitute mechanism for the "missing" takeover market in Japan.

• *Relationship between a MB and other creditors.* The MB of a firm is implicitly delegated by other financiers to monitor the firm. This ensures that lending banks do not have a free-rider problem while avoiding the costly duplication of monitoring for the same firm (as well as risk diversification). However, there is an agency problem between the MB and other creditors, because the monitoring activity is not readily observable by other financiers. Japanese MBs enjoyed a relatively high reputation in this respect until recently, with little evidence of shirking their delegated monitoring.

Sheard (1994) provides several contributing factors for this high reputation of Japanese MBs in their role as delegated monitors. First, the MB tends to bear a disproportionately large share of any assistance burden or bank losses when a firm falls into financial distress or fails. This may be considered a penalty for the neglect of monitoring or as a device to make the MB's evaluation of the troubled firm credible. Second, the MB is usually the main provider of financial services for its clients. In this role, it tends to provide insurance to corporate clients by receiving insurance premiums in good times and bearing losses in bad times (Nakatani, 1984). Finally, MBs that neglect their duties may face penalties in various forms. Other MBs may retaliate with similar actions, since they are mutual hostages as members of many loan syndicates. Also, banks with a bad reputation may be excluded from future arrangements of reciprocal delegation arrangements; and the regulatory authorities may exercise various forms of pressure and moral suasion.[4]

• *Government regulation in support of the system.* The Japanese government has long regulated/protected the banking sector, limiting competition among banks and against the capital markets. In this environment, it was relatively easy for banks to agree on reciprocal arrangements. The rents created by regulation provided an extra incentive for banks to continue behaving as good MBs by rescuing troubled customers and being faithful delegated monitors.

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[3] Sheard (1989) stresses that this role of main banks was particularly significant given that: (i) the standards of corporate accounting and disclosure have been poor in Japan by international standards; and (ii) the managerial labor market tends to be highly internalized with a high firm-specific skill component in the human capital of Japanese managers as well as consensus-based decision-making practices. This role of main banks may resolve the potential problems of the external takeover mechanism as an instrument of capital control arising from the difficulty in distinguishing between bona fide and opportunistic takeover agents engaging in the strategic exploitation of imperfect information.

[4] However, this characterization of the main bank system as a "nexus of relations," and with main banks playing typical roles, seems to be less accurate or weak for small and medium-sized firms. Minato (1999) argues that financial institutions (with the largest share of) lending to a small and medium-sized firm typically do not provide any monitoring, bailing-out, or disciplining of incompetent managers. He also states there is no "nexus of relations" (as claimed by Aoki): bank loans are extended rather independently with little social obligation to bail out the firms in times of financial distress.

2.3. Merits and Demerits of Relationship Banking

Relationship banking can add value through its contractual features that, though mostly implicit, facilitate long-term relations (Ferri, Kang and Kim, 2001; Hoshi and Patrick, 2000).[5]

- Monitoring costs are economized through reciprocal delegated monitoring among credit suppliers, virtually making the loans of a relationship bank subordinate to other banks' loans and public debt.
- Inefficient closures of distressed but economically solvent firms are prevented, and cases of corporate financial distress are effectively resolved.
- Liquidity constraints are mitigated and business risks shared between a relationship bank and its corporate clients over their cycles of cash flows and profits, since loans are made from a long-term perspective.
- Potential conflicts of interest between the creditor bank and shareholders are controlled through the holding of corporate shares by a relationship bank, easing the problem of asset substitution (investment decisions biased towards projects that enrich stockholders at the expense of debtholders; Prowse, 1990).

However, relationship banking is not without potential perils, which must be minimized by sound business judgment and discipline (Ferri, Kang and Kim, 2001; Hoshi and Patrick, 2000).

- Investment efficiency can be low due to soft-budget constraints. That is, given the good chance of loan renegotiations with their banks, firms with a relationship bank may have weaker ex ante incentives to boost their effort (Bolton and Scharfstein, 1996).
- A relationship bank might extract rents from its clients in the form of higher lending rates and others because they are informationally captured and have difficulties turning to other financing sources.
- Firms with a relationship bank may take too few risks in their businesses, as the bank will discourage investment projects with both high return and high risk.
- The system of relationship banking is often supported by heavy government regulation of the financial markets, which delays capital market (including the market for corporate control) development and results in inefficiency in the banking sector.

Given these merits and demerits, the effects of relationship banking on borrowing cost, credit availability, and corporate performance cannot be predicted *ex ante*. The

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[5] It is difficult to describe the MB system in specific terms, because the contracts involved are largely implicit. Boot, Greenbaum, and Thakor (1993) explain the use of legally unenforceable, discretionary financial contracts in circumstances where legally enforceable contracts are feasible. The discretionary contract fosters reputation enhancement, thereby increasing future fee income. The better the guarantor's reputation, the greater is its incentive to write discretionary contracts, and a discretionary guarantee of a highly reputed guarantor can be more valuable than an enforceable guarantee of a less-reputable guarantor. Examples include holding company cross-guarantees ("comfort letters"); mutual fund contracts (discretionary guarantees); loan commitments; an investment bank's "firm commitment" underwriting a contract; price-stabilization promises for new bonds and equity issues during the issuance period.

average borrowing cost of a firm with a relationship lender will be lower only when the savings on monitoring costs and the positive effect of risk reduction more than compensate for the negative effects of the lender's monopoly rent extraction. Credit availability is higher only when the positive effects of reduced information asymmetry and reduced risk (as well as soft-budget constraints) outweigh the negative effects of discouraged risk-taking (lower investment and slower growth) and the information monopoly by the bank. Likewise, the impact on corporate efficiency and performance will also be determined as a net effect of the various positive and negative factors. Thus, we have to rely on empirical studies to answer these and other related questions on relationship banking.

2.4. Banks' Holding of Equity Shares of Client Firms

Relationship banks in Japan and Germany tend to hold equity shares of their corporate clients as a way of cementing the relationship. As already mentioned, this alleviates potential conflicts of interest between creditors & equity holders and the associated problems of asset substitution, and under- or over-investment (Jensen and Meckling, 1976; Myers, 1977). As residual claimants as well as creditors, the banks have stronger incentives and capacity to monitor client firms, and their incentives for the premature liquidation of troubled firms are reduced.

However, some side effects can also be expected from a creditor bank that is also a shareholder. First, if the client firms of a shareholder-bank face smaller credit constraints, these soft-budget constraints can lead to investment inefficiency. Second, the shareholder-bank might use its stronger voice to distort corporate decisions to protect its own interests as a creditor (by discouraging risky but firm-value-increasing projects). This is a result of the fact that banks' equity stakes in client firms are usually much smaller than their stakes as creditors.[6] Finally, a shareholder-bank's power over its client firms can lead to the extraction of increased rents (Morck, Nakamura, and Shivdasani, 2000).

Flath (1993) finds that the largest debt holders in Japanese *keiretsu* firms hold more stock if the firms borrow heavily, have weaker collateral, have greater prospects of growth, or have high levels of spending on R&D or advertising. This finding is consistent with the expectation that creditor banks are more interested in holding the shares of client firms with potentially high agency problems. These firms include those with relatively high information asymmetry and temptations for asset substitution. He also finds that *keiretsu* firms in which debt holders hold more stock borrow more. Prowse (1995) also finds that banks' shareholdings are significantly correlated with their lending to the firm especially for firms operating in relatively risky environments. This complementarity between equity and debt holding by banks can be interpreted as a result of banks' attempts to protect their position as lenders, or the result of mitigated agency problems.[7] According to a survey on cross-shareholding with financial institutions conducted on Japanese exchange-listed companies, few firms regard the cross-shareholdings as beneficial in terms

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[6] In this connection, interviews with Japanese bankers in 1999 reveal that corporate governance by Japanese banks is conducted through financing, rather than through shareholdings (Hirota, 1999).

[7] Creditor banks that also hold equity shares in financially distressed firms face potentially serious conflicts of interest in the presence of other fixed claimants (Berlin, John, and Saunders, 1996). It was observed that German bankers seldom take equity stakes when firms enter financial distress (Edwards and Fischer, 1994). For US banks as well, it is mainly conflicts among fixed claimants rather than regulatory restrictions that restrict banks' equity positions in distressed restructurings (James, 1993).

of financing (lower borrowing interest rates or increased availability), but most expect support during financial distress and believe the cross-shareholding will be continued in the future (Wakasugi, Omura, and Miyashita, 1994).

3. Empirical Aspects of Relationship Banking

Relationship banking entails several behavioral aspects of banks that may be observable through empirical investigation. A relationship bank may make more credit available to its clients and mitigate their liquidity constraints; may reduce and share their business risks; may allow the firms to fare better in financial distress, often intervening in their management; and may affect their efficiency and profits.

3.1. Credit Availability and Mitigation of Liquidity Constraints

Many studies find that firms with a relationship bank enjoy easier access to credit.[8] As indicated by Fukuda and Hirota (1996), this may be the result of the simultaneous determination of the MB relationships and the debt ratio. MB relationships increase corporate debt capacity by reducing the agency cost of debt, while firms with high debt ratios strengthen their MB relationships due to the associated agency problems. As far as credit availability is concerned, the effects of reduced information asymmetry and risk seem to outweigh the effects of discouraged risk-taking and information monopoly by relationship banks. This, however, does not necessarily mean that firms with a relationship bank grow faster. In fact, firms with a MB do not seem to grow faster than other firms because risk-averse banks discourage investment into risky projects even if the expected return may be very high (Nakatani, 1984; Weinstein and Yafeh, 1998).

Liquidity, or internal funds, is more attractive as a source of corporate investment given the information asymmetry between borrowers and lenders as well as incentive problems arising from the dilution of ownership stake due to external financing for the managers controlling the firms. With closer monitoring by MBs, Japanese firms might be expected to be little constrained in their investments. In other words, the investment of firms with a main bank might be less sensitive to firm liquidity.[9]

Several studies on Japanese MBs find them to have a significant role in mitigating liquidity constraints for corporate investment. Investment was found to be less sensitive to liquidity (or long-term debt) for firms with a MB or stronger links to a MB in terms of the

[8] They include Fukuda and Hirota (1996) for Japan; Elsas and Krahnen (1998), Harhoff and Körting (1998) for Germany; Angelini, Di Salvo and Ferri (1998) for Italy; Petersen and Rajan (1994) and Cole (1998) for the US.

[9] Kaplan and Zingales (1997), however, question the use of sensitivity of investment to cash flow as a reliable measure of "liquidity constraint" defined as "a wedge between the internal and external costs of funds a firm faces." While constrained firms should be sensitive to internal cash flow, it is not necessarily true that investment-cash flow sensitivities increase monotonically with the degree of liquidity constraints. There may be non-monotonicity in the cost function of raising external funds reflecting information and agency problems. Precautionary savings motives weaken the link between liquidity and investment, and irrational or overly risk-averse managers might choose to rely primarily on internal cash flows for investment despite the availability of low cost funds. Fohlin (1998a) notes that firms with the highest estimated liquidity sensitivity showed no real signs of liquidity constraints, indicating the potential for misleading conclusions when liquidity sensitivity is used to measure liquidity constraints.

level or stability of MB loan share, and MB ownership share (Hoshi, Kashyap, and Scharfstein, 1991; Mori, 1994). Tomiyama (2001) makes an indirect test of the same question, finding that the speed of employment adjustment in a financial crisis tends to be slower for firms with a strong MB relationship (in terms of ownership and loan shares of MB, etc.). This is seen as the result of their being less liquidity constrained. Hayashi (2000), however, finds no evidence that MB ties mitigate the firm's liquidity constraints.

For German firms, Elston and Albach (1995) find some evidence that firms with significant bank ownership stakes had no liquidity constraints in the 1980s, unlike firms without a bank blockholder. However, Fohlin (1998a) finds that German firms with bank attachments, or even long-term bank relationships, were not associated with any significant reduction in their liquidity sensitivity of investment or rate of investment for the period 1903 to 1913, the formative years of universal banking.

For publicly traded U.S. firms, Houston and James (1995) find that firms relying on a single bank were significantly more cash flow constrained in the period from 1980 to 1993. The investment sensitivity to liquidity increased monotonically in the ratio of bank debt to total debt outstanding, an indication that they faced higher costs of external financing. They also held larger stocks of liquid assets and had lower dividend payout rates.[10]

Capital market deregulation and liquidity constraints

Some studies on Japanese banks investigate changes in the role of MBs since the 1980s, when Japan pursued capital market liberalization, asking whether they contributed to the generation of the bubble. The free-cash-flow hypothesis is often put forward in support of the argument that investment funded by securities issues in the 1980s was inefficient in the sense that some investment projects reduced corporate values (Jensen, 1986).

No particular role after the capital market deregulation? Hisatake and Oiwa (1999) find that firms with a MB could only have liquidity constraints mitigated before 1985 among Japanese heavy and chemical industrial firms, but that all firms permitted to issue convertible bonds without collateral did not face liquidity constraints thereafter. Weinstein and Yafeh (1998) also find that MB clients had significantly better access to capital prior to 1980 than other firms, an advantage which largely disappeared following the financial liberalization in the early 1980s.

Did MBs contribute to the asset price bubble and its collapse? In the period when Japanese firms were able to raise funds rather easily with equity issues and collateral-backed loans, it was found that MBs did not promote investment in securities or real estate through their loans. Still, they overlooked or encouraged over-investment on these assets by underwriting or insuring corporate bond issues by their clients (Uchida, 2000 and 2001). Based on a "firm scale maximization" model, Uchida (1999) also finds that MBs tended to mitigate under-investment (investments with a positive net present value not

[10] Based on these findings, they suggest that informationally intensive firms (with many harder-to-value assets) are more likely to value a close (single) banking relationship (it is also more costly to establish multiple banking relationships or public debt facilities) and face costly information monopolies, and that banks are unable to completely resolve the resulting agency problems (adverse selection & moral hazard).

undertaken) problem during the high growth period in the 1960s; but caused over-investment for low-growth companies in the first half of the 1980s (the evidence is not so strong); and in the first half of the 1990s (after the collapse of bubble), seem to have eased under-investment problems for high-growth companies.

3.2. Risk Reduction and Sharing

Relationship banking can be understood as an implicit commitment between the bank and its client firm, where the bank shares the business risk of the firm, while the firm shares its profits with the bank. There are different ways for the bank to share the risk of the client firm. One is to provide assistance to the firm in times of financial distress by issuing emergency funds, or dispatching bank officials for corporate restructuring, often bearing a disproportionate share of the restructuring costs. Another way of reducing corporate risk in normal times is for the bank to ease fluctuations in corporate performance. The bank can help the client firm by lowering interest rates in times of poor corporate performance, while receiving compensation by higher rates in times of better performance. This stabilizes the financial performance of their corporate clients and reduces the probability of the firms facing unwarranted bankruptcy.[11] Of course, banks might revise their view of the viability for some of their corporate clients when witnessing the deterioration of corporate performance. In this case, they might be reluctant to provide risk sharing in this form.

Does relationship banking lower the risk of client firms?

Uchida (1997A) argues that substantial MB loans to a firm give a positive signal to other market participants concerning the quality of the borrower, its profitability and its riskiness. Other lenders are likely to give low appraisals to the firm's potential problem of moral hazard as the MB is expected to closely monitor and discourage investment projects with excessive risks. He finds that the systematic risk β, the risk indicator of individual security along the modern portfolio theory, is significantly smaller for firms that have strong relationships with MBs. He also finds that the higher the loan share of the MB, the smaller the influence of accounting data on β, and that this correlation is significant. That is, the lower the perceived risk of a company, the less the usefulness of accounting information concerning the assessment of corporate risk.[12] Another study uses bond yields

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[11] There can be other modes of risk-sharing. For instance, lenders may subsidize borrowers in early periods (in order to discourage them from taking up excessively risky investments) and be reimbursed for this subsidy in later periods (Greenbaum, Kanatas, and Venezia, 1989; Sharpe, 1990). In arm's length banking, banks are likely to charge higher rates and ask collateral early in the relationship when there are still large asymmetries of information. Only after these asymmetries are reduced through repeated transactions for some time will the banks lower interest rates and demand less collateral (Boot and Thakor, 1994).

[12] MB client firms are likely to adopt a profit smoothing accounting policy since they have strong incentives to show that they are good borrowers with low risk and stable profits. Consequently, their accounting information might be more useful as information about on current and future cash flow level than is the case for firms with a strong MB relationship. Uchida (1997B) finds a stronger association between unexpected profits (using the change in profit rate as a proxy) and cumulative abnormal return on equity for firms with a strong MB relationship.

as a measure of corporate risk, and finds no evidence that firms with a (bank) group affiliation were less risky for the period of 1983-92 (Hall and Weinstein, 2000).[13]

Risk- sharing

Kawai, Hashimoto and Izumida (1996) find that firms with bank borrowing (particularly those with MBs) tend to pay significantly lower interest rate premia in times of financial distress, while the opposite is the case for other firms for the period of 1964 through 1993. They identify a MB relationship as a single largest commercial bank lender that has remained unchanged at least for five years prior to the beginning of the financial distress as well as during the distress – a total of 10 years. Li (1999) finds significant risk-sharing in 46 percent of chemical and electronics industrial firms with a MB (higher than the 30% found by Horiuchi and Fukuda, 1987). He interprets this as supporting evidence for risk-sharing. Based on a regression analysis of the risk sharing coefficient (the share of the gap between corporate profit and normal lending rate reflected in the actual lending rate), Aman (2000) finds that MB relationships (MB delegation of directors or MB loan share) for Japanese chemical industrial firms had a significant risk-sharing role until 1985, while since 1986 the role has weakened or disappeared.

Collateral prices and risk-sharing. Saito and Sudo (1999) derive the response rate of risk-sharing to collateral value using a dynamic optimization model using some assumptions concerning MB decisions on the amount and interest rate of loans. They show that until the early 1980s, city banks provided "normal" insurance functions toward their client companies on the basis of increases in collateral value of real estate. With the asset bubble in the late 1980s, there was a substantial substitution effect for the insurance function. In the 1990s, with the collapse of the asset price bubble (and no longer any substitution), the insurance function of city banks continued to be damaged.[14]

3.3. Better Assistance in Periods of Financial Distress

Relationship banking is held to be most valuable in times of financial distress for borrowing firms. On the basis of information obtained in the process of relationship-based monitoring, relationship banks tend to respond quickly to the distress by mitigating liquidity constraints, restructuring debt, and undertaking the needed operational restructuring of borrowing firms. As a consequence, the probability of unwarranted bankruptcies should be lower. Among Japanese firms that experienced financial distress but recovered thereafter, firms in industrial groups (which thus had close financial

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[13] Prowse (1992) shows evidence that financial institutions' equity investments in independent firms are very sensitive to the benefits accruing from exerting control over firms with unstable environments (larger variation of profit rates measured by both stock and accounting returns). This indicates that financial institutions, including banks, can mitigate the high risk of their clients by better monitoring management as a major shareholder.

[14] Collateral gives the lender greater incentive to liquidate failing firms, while an unsecured lender has little incentive to take actions that might lead to a run on the firm. This reduces the moral hazard problem on the part of borrowers. However, fully secured lenders have no incentives to monitor borrowers (Rajan and Winton, 1995). Also, collateral signals borrower quality, giving the lender additional information about the borrower in the process of inspecting the collateral (Picker, 1992).

relationships to their affiliated banks, suppliers, and customers) invested more and sold more after the onset of distress than non-group firms during 1978-85. Similar results were found for non-group firms that nevertheless had strong ties to a MB with a high ratio of MB loans to total loans (Hoshi, Kashyap, and Scharfstein, 1990; Okazaki and Horiuchi, 1992). Hall and Weinstein (2000) find that firms with a large share of bank loans from the top lender received more loans from that lender and all lenders in times of financial distress during 1983-92. What is important is not the MB relationship, but concentrated debtholding that mitigates the free-rider problem and facilitates the MB's role as a coordinator of the creditors.[15]

Although Japanese firms with strong MB relationships seem to have been better assisted than those without such relationships during financial distress, how do Japanese firms in general compare with their American counterparts? Hall and Weinstein (1996) examine the investment behavior of U.S. and Japanese firms after the onset of financial distress. They find that financial distress causes R&D to fall in both countries by approximately the same amount, and that Japanese firms do not invest more than US firms after the onset of distress.

Results for small and medium-sized Korean firms are provided by Ferri, Kang and Kim (2001). As expected, they find that, for firms with strong pre-crisis relationship banking, outstanding loans decreased less, the drops in credit lines were smaller after the crisis, and the chance of building (increasing) their loans in arrears in 1998 (the year of the sharpest liquidity constraints) was lower (for previously non-delinquent firms).

Is more credit available when the relationship bank is also a significant shareholder? Hall and Weinstein (2000) present an interesting finding about the lending behavior of banks when the top lender also has a large equity stake. No significant impact on lending by the lender was found, while significant reductions were observed in lending by other financial institutions or total lending. This suggests that other banks perceive a conflict of interest between themselves and the top lender, who might compromise its position as a creditor with that of a shareholder.

3.4. Management Intervention in Financially Distressed Firms

In a stable, relationship-based system with MBs, corporate shareholders, and corporate groups, external corporate governance tools such as takeovers and proxy fights are rare. In such systems, the key to the efficiency of the system is whether or not the MBs and other corporations with stable relationships properly monitor and discipline the managers, or in other words, whether the relationships substitute for the more market-oriented US control mechanisms. Many empirical studies seek evidence for timely management intervention by MBs or other block holders when corporate performance deteriorates.

Japanese MBs are seen as providing a flexible, informal alternative to bankruptcy proceedings when managing the problems of financial distress and asset reorganization (Scheard, 1994). An announcement of the waiver of creditor rights has been observed to have little effect on the stock price of the MB, while having a significant positive effect on

[15] Miwa and Ramseyer (2001) and Miwa (1985) presuppose that if MBs play their expected roles, the present MB of 'a distressed firm' is more likely to be the same as its MB ten years earlier, and that the MB loan share will increase in times of distress. They, however, find that the replacement rate of MB (the largest creditor) is higher for distressed firms, and that MB loan shares show no significant changes between 1973 and 1984.

that of the defaulted firm. These positive-sum stock responses reflect investor expectations for the MBs' role in efficiently restructuring distressed firms (Uchida and Goto, 2001).

Kaplan and Minton (1993) find that the appointment of outside directors in Japan is followed by a turnover of incumbent managers, with bank appointments strongly correlated with the debt/assets ratio and the loan share for the largest lender. Kang and Shivdasani (1995) also find that non-routine top executive turnovers in Japanese corporations are significantly related to industry-adjusted returns on assets, excess stock returns, and negative operating income. This relationship and the likelihood of outside succession are found to be stronger for firms with a MB relationship. Miyajima, Kondo, and Yamamoto (1999) investigate the association between appointments of outside directors and firm performance for the largest Japanese firms, and find that banks systematically intervened in the management of distressed firms for monitoring during the high-growth period. There were sharp improvements in performance after the appointment of outside directors until the 1980s. However, they find no such relationships during the first half of the 1990s following the collapse of the bubble.

Are intervention standards different for non-group firms? Morck and Nakamura (1999) find that the appointment of bankers to corporate boards is positively associated with total debt, bank loans, and bank group links as well as cash flow and liquidity problems. Low stock returns and poor employment creation matter for bank group firms, but not for other firms. This finding was interpreted as meaning that Japanese banks act primarily in the short-term interests of creditors when dealing with firms outside of bank groups, while acting in the broader interests including those of shareholders when dealing with group firms. They also find that the share prices of bank group firms rose in the year of the appointment, and remained high, while those of other firms did not rise in the year of appointment and fell significantly in the following year to remain depressed.

Comparison between Japanese and U.S. firms

Some studies show that Japanese banks and blockholders perform some of the monitoring or disciplinary functions generally performed by the takeover market in the U.S. Many Japanese firms that experienced performance deterioration during the second half of the 1980s, like US firms, saw a contraction of assets and operations, significant changes in employment practices, and turnover of top executives, though their downsizing of assets and layoffs took place on a smaller scale. It is also found that firms with greater MB ownership were more likely to engage in asset restructuring, employee layoffs, and removal of outside directors among poorly performing firms (Kang and Shivdasani, 1997).

Kaplan and Minton (1994) find that appointments of bank and corporate directors increased significantly with poor stock performance (and earnings losses in the case of bank directors) and with measures of the intensity of the relationships (larger bank borrowings, or a large loan share for the top lender, concentrated shareholding, affiliation with a corporate group) in Japan. After bank directors arrive, corporate performance does not deteriorate in Japan, though the firms continue to contract. These findings compare favorably with those of U.S. firms, where appointments of outside directors were generally less sensitive to corporate performance and not associated with top executive turnover. Similarly, Kaplan (1993a, b) finds that manager compensation and turnover are more sensitive to earnings deterioration in Japan and Germany (than in the U.S.).

3.5. Effects on Firm Efficiency and Performance

Although close bank-firm relationships solve the asymmetric information and agency problems of managerial behavior, these benefits do not necessarily lead to superior corporate performance. The benefits may be largely appropriated by the banks, and the banks may discourage firms from investing in risky but profitable projects (Weinstein and Yafeh, 1998). MB monitoring and interlocking shareholding effectively substitute for the "missing" external takeover market in Japan (Sheard, 1989).

Lower capital costs?

Hosono (1997) finds that the lending interest rate spread was significantly negatively affected by the MB (the largest short-term lender) loan ratio in total debt during the 1982 to 1995 period for exchange-listed Japanese firms. However, the finding applied mainly to medium-sized companies, not for large firms. Based on the US National Survey of Small Business Finance, Petersen and Rajan (1994) find that the interest rates charged are little affected by the length of relationship or multiple services; while multiple banks are associated with a significantly higher rate.[16] Relying on the same data set, Berger and Udell (1995) focus exclusively on lending under lines of credit, which represents more "relationship-driven" loans. They find that borrowers with longer banking relationship pay lower interest rates and are less likely to pledge collateral. [17]

Weinstein and Yafeh (1998), however, observe that Japanese MBs extracted significant rents through higher-than-average lending rates before the liberalization of the financial markets in the 1980s. Angelini, Di Salvo and Ferri (1998) also find that lending rates tend to increase with the length of the bank-firm relationship in Italy. In Germany, relationship banking is found to have no major impact on loan pricing (Elsas and Krahnen, 1998; Harhoff and Körting, 1998).

Better performance for firms with a relationship bank?

The Small and Medium Size Enterprise Agency (2000) finds that SMEs with close relationships with MBs (with bank shareholding in the firm) tend to have higher profits (ROA), sales growth, presence in new businesses, and withdrawal from non-profitable projects. Lichtenberg and Pushner (1994) find that the block holding of corporate equity shares by financial institutions is associated with better corporate performance.[18]

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[16] Petersen and Rajan (1994) suggest that a single bank relationship might be a proxy for the lower quality or higher riskiness of firms. They provide other explanations as well: relationship increases information monopoly; cost of credit does not matter much because the marginal return from investment is usually much higher under credit rationing; and loan officers usually have larger discretionary power in deciding the availability rather than the pricing of the credit they supply.

[17] Using the US Small Business Survey data, Scott (2000) shows that low accounting manager turnover and frequent social contact with the owner of the firm, which represent an aspect of strong relationship banking, have similar effects – significantly increasing credit availability and lowering loan rates.

[18] Lichtenberg and Pushner (1994), however, find that ownership of other corporations had a negative effect on corporate performance. Their conjecture is that non-financial corporate ownership might insulate the firms from their own problems or market forces at the expense of profit/productivity; corporate owners might also encourage non-profit-maximizing behavior in their own interests. They also find a positive effect of director

Several studies find that Japanese firms with a MB tend to have lower profits due mainly to the bank extracting rents from its client firms in the form of higher interest on the basis of its informational monopoly (Caves and Uekusa, 1976; Nakatani, 1984; Weinstein and Yafeh, 1995 and 1998). The lower cost-price margins found for *keiretsu* firms may reflect the tendency of the bank to encourage them to produce in excess of the pure profit maximizing level for the interests of other *keiretsu* firms (Weinstein and Yafeh, 1995). Morck, Nakamura, and Shivdasani (2000) find that equity ownership by a MB is negatively related (non-linearly and evident at low to moderate levels of bank ownership only) with firm value (q ratios) for exchange-listed Japanese manufacturing firms in 1986.[19] This finding is consistent with the argument that moderate ownership levels significantly increase a bank's power to appropriate surplus from client firms and that bank ownership is associated with relaxed financial constraints. Nitta (2000) finds stable shareholdings, especially those by banks and cross-shareholdings with non-financial companies, have a negative influence on corporate performance (stock prices, sales, ordinary profits, sales-to-profit ratios, ROA and ROE), while shareholdings by foreigners have a positive influence.

Technical efficiency of firms. Several studies concentrate on total factor productivity of firms as a measure of corporate managerial efficiency to investigate the effect of relationship banking. They find no positive effect of the MB relationship for large Japanese manufacturing firms (Hanazaki and Horiuchi, 2000 and 2001; Gower and Kalirajan, 1998). Rather, Hanazaki and Horiuchi (2000 and 2001) find a significant positive impact of market competition (particularly competitive pressures form abroad) as well as the debt/asset ratio (even though the latter effect was weaker in the 1980s), which is consistent with the hypothesis that debt disciplines corporate managers, as they are concerned about repaying debt (Grossman and Hart, 1982; Jensen, 1986). Gower and Kalirajan (1998) also find that the technical efficiency of Japanese manufacturing firms with close ties with a MB did not improve consistently and significantly in the 1980s.

Direct evidence of disciplining management. Kato (1997) provides direct evidence of a positive role for the inter-corporate relationship in corporate monitoring for Japanese manufacturing firms. He finds that CEOs of *keiretsu* firms earn 21% less than those of independent firms, and that the role of capital investment in the determination of CEO pay is more important for *keiretsu* firms than for independent firms. This indicates that the CEOs of *keiretsu* firms are rewarded for promoting capital investments (corporate expansion) that seem to be in the interests of the MB and other *keiretsu* firms. Similarly, Yasha and Yafeh (1998) provide evidence of management disciplining by large shareholders in Japanese firms. Concentrated shareholding (shares for the 10 largest shareholders, or for group members) was found to be associated with lower expenditures by management on activities that might generate private benefits such as R&D, advertisement/promotions, entertainment, general sales and administration. Evidence of such monitoring by creditors was also found, though it was less robust.

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ownership indicating that ownership reduces the agency conflict between managers and shareholders.

[19] However, they find q ratios rising monotonically with both ownership by management and corporate block holders. This indicates that large block holders are a way of overcoming the free-rider problems associated with dispersed ownership.

Better performance for firms with a MB and an efficient monitoring system. MBs have different monitoring systems. Tomiyama, Fukao, Sui, and Nishimura (2001) find that firms with a MB that have a better monitoring system demonstrate better accounting performance. The ratio of monitoring staff to total staff in the headquarters was found to have a significantly positive effect, while a proxy for the independence of the monitoring unit had positive but not significant effect for large Japanese firms during 1986-97.

Why the banking problem in Japan?

The Japanese banking sector has been in distress since the asset bubble collapse in the 1990s, with a large accumulation of non-performing loans. Some attribute this to the financial deregulation which began in the early 1980s, and undermined bank profits as well as their motivation to prudently monitor their client firms (Hellman, Murdock and Stiglitz, 1996).

However, Hanazaki and Horiuchi (2001) argue that the problem came not from deregulation, but from the comprehensive safety net provided by the financial authorities and the slow process of financial deregulation, which shielded incumbent financial institutions during the high growth period. Banks' monitoring was largely neglected, as the government or market forces were unable to penalize inefficiently managed banks, making the sector potentially fragile even before the 1980s. They explain the Japanese banking problem with changes in banks' major clients. As most reputable manufacturing firms no longer relied heavily on bank borrowings, the newly emerging major clients were firms in non-tradable sectors such as real estate. Unlike manufacturing firms, which are disciplined by foreign competition, these new clients needed to be closely monitored, but were not closely watched by banks. This neglect, combined with the asset-price bubble following the financial expansion, led to the drastic deterioration of bank loan portfolios.

Effects of German universal banking

Cable (1985) finds a generally significant positive impact on firm performance from interaction with banks for a sample of large publicly-held German firms. Along with the ratio of bank borrowing to total debt, more direct governance variables such as supervisory board representation and proxy voting also had a positive effect on profits. Schmid (1996) finds that corporate ROE displayed a U-shaped pattern as banks' equity holdings increased, with interest rate on debt monotonically increasing for German firms. This finding is consistent with the prediction that, at a low level of ownership, banks use the increased ownership and voting power to divert earnings away from equity, but such incentives weaken with a further increase in equity shares.

Gorton and Schmid (1996) investigate the effect of bank-firm relationship (equity holding and proxy voting) on corporate accounting profits in Germany. For 1974, they find a positive effect of banks' holdings of equity shares on corporate performance, while bank use of proxy votes did not have any impact on firm performance. In 1985, however, neither banks' equity ownership nor proxy voting had any effect on firm performance (beyond that of other blockholders). The interest burden on debt was also found to be little affected by the bank-firm relationship. Bank representation on firms' supervisory boards was also not found to lead to higher rates of investment or increased access to bank debt (Fohlin, 1997, 1998b), and was even negatively associated with the firms' rates of return (Rettig, 1978;

Tilly, 1994). Edwards and Fischer (1994) argue that it is impossible to conclude anything about the contribution of the German financial system to its (post-1945) economic performance (growth, investment rate, etc) on the basis of simple correlations.

3.6. Changes in Relationship Banking since the 1980s

Many people find that the practice of relationship banking has changed, particularly in Japan since the 1980s. There have been two distinct forces underlying these changes. One is the deregulation of financial markets, particularly corporate bond issues, and the other is the severe distress of the banking sector following the bubble collapse in the early 1990s. These two forces seem to have operated in the same direction in some respects, while working in opposing directions in others. For instance, financial market deregulation has weakened the MB relationship, while the prolonged recession and the increased risk of corporate default has made the MB relationship more important for many firms.

Overall, there do not appear to have been major changes in the MB system since the 1980s. Hirota and Horiuchi (2001) find that MB relationships have been rather stable even in the 1990s for the largest Japanese firms in terms of MB financing, shareholding, delegation of executives, and businesses related to debentures. They identified each firm's MB based on a direct question to the largest Japanese firms, since MB relationships include many dimensions.

Table 1. Stability of MB Relationships: Share of Firms that Switched MBs

(1980-97; %)

Definition of MB	1980→1985	1985→1990	1990→1995	1995→1997
Based on direct question	2.4	2.3	2.0	1.6
Top lender bank	19.4	16.8	11.6	6.3

Source: Hirota and Horiuchi (2001).

The rate of change is remarkably low, at around 2 percent every 5 years. The result, however, is very different from that based on the definition of the MB as that with 'the largest loan share' (see Table 1). This definition has a problem for the purpose of studying MBs. Namely, the bank with the largest share does not necessarily have a long relationship with the firm (the bank with 'the largest loan share' often changes due to occasional surges of long-term borrowings from long-term credit or trust banks). Even though the share of MB loans in total corporate debt declined substantially in the first half of the 1990s, other MB functions, such as corporate ownership, delegation of officers and provision of trustee services for corporate bond issues, have not shown any marked decline (see Table 2).

Table 2. Trends of Corporate Relationships with MBs

	1980	1985	1990	1995	1997
Loan Share (%)[1]	24.16	22.32	16.05	16.13	17.71
Ownership Share (%)	4.98	4.77	4.06	4.12	4.14
# Delegated Managers	0.83	0.72	0.72	0.73	0.73
% CB Trustee Service [2]	87.25	87.38	83.35	82.28	79.22[3]

Notes: [1] Loan Share = share of MB loans in total debt (loans and CB).
[2] % of CB Trustee Service = ratio of firms for which the trustee of CB issuance was the MB, to the total number of firms which issued CBs.
[3] This decline was due mainly to the increase in trustee service by MB-affiliated security companies.

Source: Hirota and Horiuchi (2001).

With the sharp increase in corporate defaults and non-performing loans, the attitudes of MBs and their corporate clients seem to have changed. Evidence shows that MBs have become more cautious about lending to risky firms, while many less creditworthy firms are more willing to accept MB monitoring in return for help in times of financial distress. During 1990-95, MB loan shares for distressed firms showed a tendency to decline. Economic Planning Agency (1997) interprets this as showing that MBs have become more cautious (and are tending to rely on monitoring) in selecting their clients since the collapse of bubble, and are trying to have relations with better companies, without having to provide easy bail-outs. It was also shown that the loan share of the MB is negatively affected by the risk of its borrowers (total debt) and positively affected by the (expected) profit/sales ratio. Miyajima and Arikawa (1999) analyze the debt selection pattern of major companies following the collapse of the bubble in Japan. Among firms with MBs, those with high expected returns tended to choose corporate bonds in the 1980s, probably to avoid bank monitoring, but this was no longer the case after the burst of the bubble.

In a survey conducted of all exchange-listed and over-the counter-traded companies in 1999, SMEs expressed a desire to strengthen their relationships with financial institutions, including MBs. This may be surprising, as Japanese firms are changing their financing modes, relying more on direct financing such as bonds, stock, CP, etc. Large companies also expressed a willingness to maintain their existing relationships with MBs. However, their expectations from banks seems to have changed: from the function of lender of last resort to the more explicit help of extending credit lines and emergency funds (Omura and Masuko, 2001).

Clearly, the functions of relationship banks are undergoing changes. As discussed earlier, many studies show that Japanese MBs were engaged in relationship-based information production and monitoring until the capital markets was liberalized in the mid-1980s. As firms gained the ability to easily issue convertible bonds, however, liquidity constraints became less of a problem even for firms without a MB (Hisatake and Oiwa, 1999; Weinstein and Yafeh, 1998). The risk-sharing function was also significantly weakened or eliminated (Aman, 2000), being replaced by the asset price bubble in the late 1980s or being damaged by the burst of the bubble thereafter (Saito and Sudo, 1999). With their weakened role, Japanese MBs seem to have lost the power to extract rents from their clients (Weinstein and Yafeh, 1998). Since the 1980s German banks also can no longer affect firm performance (Gorton and Schmid, 1996). Japanese MBs have become less willing and less capable of providing rescue to their clients in financial distress since the 1990s (Miyajima, Kondo, and Yamamoto, 1999; Economic Planning Agency, 2000).

On the basis of the above review of empirical evidence, what can be said about the behavior of relationship banks or the merits and demerits of relationship banking? Table 3 provides some tentative answers to this question. Given that the review of evidence was not exhaustive and that there is still only scanty evidence on some aspects of relationship banking, this evaluation also reflects a judgment by the author on the strength of the theoretical argument. Evidence on the positive role of relationship banking seems to be fairly strong in at least three aspects. It gives client firms better access to credit, alleviating liquidity constraints in investment activity; it reduces the costs of financial distress as the banks can provide better care to troubled firms, often intervening in their management; and it tends to reduce the business risk of the firms. Firms with a close banking relationship generally do better in financial crisis, though they are affected more severely when their own relationship banks fall into serious distress. Evidence on the extraction of monopoly rents by relationship banks from client firms is mixed, although this tendency seems to be rather evident for Japanese main banks. In spite of the increased availability of credit, firms with a close banking relationship tend to grow more slowly than other firms, as the banks discourage risky projects. Finally, the evidence on corporate efficiency and profits is rather negative.

Table 3. Empirical Evidence on Relationship Banking

Main Features of Relationship Banking	Overall Evaluation
Better access to credit	
Increased credit availability	○
Lower investment sensitivity to liquidity	○/△
Business risk shared by banks	
Less risk of client firms	○/△
Risk sharing through interest rates	△/○
Financial distress more effectively overcome; timely management intervention	○/△
Firms faring worse in economy-wide financial turbulence (when banks themselves are in distress)	△/○
Monopoly rents charged on client firms	△
Faster corporate growth	×/△
Higher corporate efficiency and profits	×/△

Note: ○ yes; ○/△ largely yes; △/○ weakly yes; △ mixed; ×/△ largely no.

4. Constraints and Risks of Relationship Banking

Banks face several constraints as they attempt to exercise corporate governance in an efficient way. First, given their own poor corporate governance, they may have weak incentive for genuine relationship banking or may use this practice with perverse or distorted incentives. Second, a relationship bank may face a potentially serious conflict of interest when it intervenes in the management of a financially distressed firm. Third, with deregulation and increased competition in the financial markets, the incentive for banks to invest in relationship-specific information production is weakening. Finally, relationship banking may be jeopardized in a financial crisis, when banks cannot fulfill their implicit obligation to provide rescue and restructuring services to distressed firms.

4.1. Corporate Governance in Banks

The realization of whatever benefits can be expected from relationship banking depends on sound corporate governance in the banks. Otherwise, they will not have much incentive to invest in relationships, or relationship banking practices might simply serve as a convenient tool for distorting the allocation of bank resources. If banks are directed (by the government, bureaucrats or politicians) to lend to specific sectors and firms, the room for relationship-based banking is limited. The same is true if banks are owned and controlled by non-financial business groups. The controlling owners will have a strong incentive to use bank loans and other services to benefit their group or family rather than all the shareholders of the bank. There is little incentive in this case to have a close banking relationship with this bank for firms that are not subsidiaries of the group or otherwise have close business linkages.

Some of the external mechanisms of corporate governance are weaker in banking than in non-financial industries. For instance, the market for corporate control for banks is restricted by the regulations on the qualification of potential acquirers or the prior approval of the bank regulator. The discipline of the product market is also weak due to the oligopolistic markets for some banking services. The typically diffuse ownership structure and the consequent free-rider problem also make it unrealistic to expect effective monitoring by shareholders. Meanwhile, the deposit insurance system often encourages moral hazard behavior by banks such as excessive risk-taking. In return for the provision of deposit insurance, the financial regulatory authorities are justified in monitoring and disciplining bank management. Bureaucracy and political interference, however, makes the regulator far from an efficient and effective monitor.

Analyzing 234 cases of corporate control changes among bank holding companies in the U.S. over the period 1987-92, Prowse (1995) finds that hostile takeovers or friendly mergers did not play an important role as a means of disciplining bank managers, and that the internal control device of board-induced management turnover was not used as frequently as in manufacturing, particularly for manager-entrenched banks. Regulators providing last-resort control mechanisms were found to exercise their regulatory intervention mainly over banks with markedly low ownership concentration. Other studies show that banks with entrenched management tend to most actively engage in acquisition programs that are likely to increase the perquisites available to management, simply because of their bigger size (Allen and Cebenoyan, 1991). In addition, banks with managements that are relatively free from outside shareholder control tend to make the riskiest and most unprofitable investments (Gorton and Rosen, 1992).

Spong, Sullivan, and De Young (1995) identify a number of characteristics (financial, ownership, and management) of the most efficient and least efficient banks in the Tenth Federal Reserve District of the U.S. They find that efficient banks are associated with:

- Board of directors – more frequent meetings; higher director fees; and members with a higher average net worth, a greater equity share, and better attendance rate
- A strong ownership group or management with a vested interest in the bank (rather than diffuse ownership with hired managing officers)
- Higher compensation for managing officers.

The Japanese banking problems since the early 1990s are also often attributed to a corporate governance vacuum in banks where managers enjoyed wide latitude (Hanazaki and Horiuchi, 1998).

- Banks are generally more diffusely held than other exchange-listed firms. Small shareholders suffer from the free-rider problem, which is further worsened by the comprehensive safety net – in the form of the rescue of distressed financial institutions – provided by the government.
- Competition – another powerful means of discipline – has not been effective due to the delayed deregulation in the financial markets with the restriction of new entries and the compartmentalization of the sector.
- The supervision by regulatory authorities over banks has been also problematic. The practice of post-retirement service for high-level government officials on the boards of private firms (*amakudari*) has been common for banks, undermining the effectiveness of monitoring by the regulatory authorities (Horiuchi and Shimizu, 1998).

Hanazaki and Horiuchi (1998) analyze the performance of 125 regional banks (capital/asset ratio and bad loan ratio) for the period of 1985-89, and find that firms with *amakudari* officers from the MOF had significantly worse performance. This evidence is contrary to the argument of Aoki, Patrick, and Sheard (1994) that the *amakudari* system disciplines financial authorities to effectively monitor bank management. Their argument is that regulatory authorities have strong incentives to rigorously monitor banks in order to secure good jobs for their officials after retirement. Rixtel and Hassink (1998) is another empirical study on the efficiency of the practice of *amakudari*. They find that banks accepting *amakudari* officers tend to have poor profitability, deteriorating solvency or declining growth in lending to construction, real estate, and non-bank financial industries. They also found that MOF/BOJ *amakudari* appointments led to increased lending to these industries. They suggest that recapturing the lost market share in these industries might have been the strongest motivation for the practice, casting doubt on the credibility of the hypothesis that it has been used as an instrument of prudential policy.

4.2. Conflicts of Interests in Banks' Governance Role

Banks play a role in corporate governance primarily through their representation on corporate boards of directors. Commercial bankers used to be attractive as outside directors of corporations for several reasons. They provided advantages in information and facilitated stable and long-term relations with the banks; the banks tended to be in the central position of the network of interlocking directors even in the market-based system of the U.S. as well as in the bank-centered system. However, the situation has changed significantly since the 1980s. Large reputable firms now rely little on bank borrowings; with keener competition in banking, they may be reluctant to give a privileged position to a particular bank; and bankers as a source of information have become less important with the progress in IC technologies and the weakening role of banks' interlocking networks. The percentage of large firms with a commercial banker on the board is: Germany 75.0% (100 largest firms in 1974), Japan 52.9% (761 listed firms, 1992), U.S. 31.6% (Forbes 500 firms in 1992; Davis and Mizruchi, 1999).

A probably more important reason why banks are not active in their corporate governance role in the U.S. is the potentially substantial costs associated with this role in bankruptcy codes and procedures. Having a banker on the board of a firm entails a conflict of interest between the fiduciary duty to the firm's owners and to the bank employer. If a bank, with its representative on a corporate board, effectively controls corporate decisions, it may try to protect its interests at the expense of those of other stakeholders. In the event that the bank acts "inequitably" prior to a borrower's bankruptcy, it may lose senior creditor status and face liability for the losses to other stakeholders (equitable subordination and lender liability).[20]

In order to avoid this complication, banks opt to maintain an "arm's length" relation with their corporate clients, and are very cautious about their officers being represented on corporate boards. To the extent that board representation helps banks' corporate governance role, this rule in the bankruptcy codes constrains effective monitoring and control activities by banks. Thus, bankers tend to be on the boards of firms where they are not likely to face the cost of lender liability: large, stable, and better performing firms that are unlikely to fall into financial distress. The bank represented is often not the biggest bank lender for the firm. Banks' representation on corporate boards might initially increase with the increasing volatility and deterioration of corporate performance, but is likely to decrease at higher levels of risk.[21]

[20] The concern over conflicts of interest is not just a problem for commercial banks but for other institutional investors as well. Insurance companies and investment funds are rarely active in their governance role with various regulatory restrictions on their portfolio as well as conflict of interests as they belong to larger business groups. Company-sponsored pension funds run by corporate managers themselves are particularly vulnerable to conflicts of interest. Relatively active in corporate governance among institutional investors are union-sponsored and especially public-employee pension funds. Even public pension funds that are considered the best candidates for corporate-governance activities seem to be constrained by political pressures to accommodate local interests and refrain from such activities (Romano, 1995). The governance of these funds is often problematic due to the appointment of politically affiliated members to the boards of directors.

[21] Having a banker on the corporate board, therefore, has two major functions. First, it is a means of reducing information asymmetry and disciplining corporate management. This may allow the firm to have better access to bank credit. Second, given the cost of lender liability, a banker joining the board of a firm is likely to have a certification role: signaling to the market that the firm is sound and unlikely to face financial distress. This signal lowers the firm's costs of external financing.

4.3. Deregulation and Competition in the Financial Markets

Since the mid-1970s, Japanese firms have had more options and flexibility in their financing, including increased dependence on bond issues, and this has weakened their reliance on main banks (Aoki, 1994). In the 1980s, differences in capitalization between MB client firms and other firms largely disappeared with deregulation related to the issuance of unsecured foreign bonds as well as local bonds (Weinstein and Yafeh, 1998). Deregulation and keener competition in the financial market are certainly threats to relationship banking. At the same time, another obvious trend in financial regulation is a move toward universal banking, which may provide banks with a new motivation to keep investing in relationship-specific information production and monitoring.

Deregulation, competition and relationship banking

Increased competition in financial markets may reduce the value of relationships. Keen competition may prevent banks from reaping the rewards of investments in firm-specific information production or of helping client firms at an early stage in anticipation of rents in later years (Mayer, 1988; and Rajan, 1992). This uncertainty may reduce banks' incentives to invest in firm-specific information production and relationship management. Competition, however, needs not be harmful to relational financing once the practice is more or less established. Also, banks' incentives for relation-specific investments are not necessarily weakened if competition comes largely from the capital market where relationships are not important.

First, banks require market power (a smaller number of banks and other close-substituting financial institutions) to be able to extract monopoly rents, most likely through the intertemporal smoothing of interest rates. Competition threatens relationships as the possibility of losing corporate clients to other financial institutions reduces the value of relevant information, discouraging new investments in relationships. Thus, in order to foster the emergence of relationship banking, it may be necessary to restrict competition.[22] However, as noted by Aoki and Dinç (1997), once relationship banking has become well established, the restriction may safely be removed. Because of an accumulation of information that cannot be easily transferred to other market participants, the main bank is likely to maintain its informational advantage, and its incentives for maintaining relationship banking would be continued.

Also, competition from bond markets increases the effectiveness of relationship banking, whose major role is to reduce information asymmetries. If increased competition is mainly in the area of transaction lending (such as corporate bond issues) rather than relationship lending, banks are encouraged to move to less competitive businesses and become more relationship-oriented. Banks with strong reputations as relationship lenders are least affected by competition (Boot and Thakor, 1998). For small and medium-sized firms and young firms in non-high-tech industries, a reputation mechanism that sustains a bank's rescue commitment may not be affected negatively by the increasing competition from bond markets (Aoki and Dinç, 1997). The decline of traditional commercial banking

[22] If the number of banks is too small, however, banks may be able to extract rents from the borrowers without fulfilling the duties as relationship banks. Thus, relationship banking would not emerge (Aoki and Dinç, 1997).

with the trend of securitization and increased non-bank competition will have little impact on SMEs (Berger and Udell, 1995).

Universal banking: a new avenue for relationship banking?

If commercial banks are permitted to undertake investment banking services, they can continue to utilize their private information about corporate clients even though the corporate financing pattern changes from bank loans to direct financing. In a universal banking system as adopted in Germany and other continental European countries, banks offer a full range of commercial and investment banking services including underwriting, holding and trading on their own accounts, brokerage, and securities custody business. They also sell insurance, mortgages, and investment funds usually through affiliates. Banks are not necessarily legally bound in deciding the scope of their businesses: British commercial banks have always been permitted to engage in universal and relationship banking – but have apparently often refrained (Fohlin, 1999).[23]

A major concern of the universal banking system is the potential conflict of interest, though "firewalls" can prevent this problem to some extent. In order to attract investors with concerns about conflicts of interest, securities underwritten by commercial banks may be traded at a discount (higher yields). On the other hand, commercial banks are supposed to have private information accumulated through their relationship banking that is not available to general investors in the capital market. If investors believe that commercial banks have greater ability to certify the values of new issues, they might actually trade securities underwritten by such banks at a premium (lower yields). Empirical evidence seems to indicate that the certification merit more than compensates for the concern over conflicts of interest.

The public appears to have rationally accounted for the possibilities of conflicts of interest, which constrain commercial banks to underwrite high-quality securities. Evidence in the pre-Glass-Steagall period (when there were no firewalls) shows that securities underwritten by commercial banks had a better default record in the long run and were traded at better prices than those underwritten by investment houses, despite the potential conflicts of interest (Ang and Richardson, 1994; Kroszner and Rajan, 1994; Puri, 1994 and 1996).

The separation between commercial and investment banking has been relaxed in the 1990s in both the U.S. and Japan. Evidence for the period 1993–95 in the U.S. shows that commercial banks, with their private information and certification role as monitors, bring small issuers to the market and that bank underwriting reduces yield spreads particularly for lower-credit issues, in a way that is consistent with the view that bank association is valuable for such issuers due to the bank's dominant certification effect (Gande, Puri, Saunders, and Walter, 1997).[24] A similar study was undertaken by Hamao and Hoshi (2000), who compare the characteristics of straight corporate bonds underwritten during 1994-96. They find that for issues underwritten by bank subsidiaries,

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[23] For the merits and demerits of universal banks, see Benston (1994), Diamond (1998), Fohlin (1999), and Guinnane (2001).

[24] In 1987, the Glass-Steagall provisions were relaxed: some banks were allowed to set up Section 20 subsidiaries that can underwrite corporate securities. They are subject to a substantial set of firewalls designed to limit information, resource and financial linkages between them and their parent HCs as well as with their commercial banking affiliates. Revenue generation from the securities activities of commercial bank holding companies is limited to 25% (adjusted upward from the initial ceiling of 10%).

the issue size is substantially smaller and the certification effects dominate (though not statistically significantly) the conflict of interest effects.[25]

4.4. Impact of Bank Distress in a Financial Crisis

A close relationship with a single main bank entails a risk along with the advantages. Client firms fall into trouble if the bank becomes unable to extend credit. In many cases, other banks and investors do not have full information on why firms cannot get credit from their MBs and might think they are not creditworthy. Thus, it is not easy for such firms to turn to other banks or the capital market. Evidence shows that the values of borrowing firms depend on the health of their banks (Yamori and Murakami, 1999; Slovin, Sushka and Polonchek, 1993). When the whole banking sector is in distress, high bank dependence is likely to be costly, as it makes the firm more vulnerable to shocks affecting the banking sector. If a MB is in a worse situation in this period of turmoil, its client firms may face particular difficulties in obtaining credit.

Spiegel and Yamori (2001) estimate the sensitivity of equity values of an equally-weighted portfolio of MB client firms to changes in the equity values of their MB. Introducing a structural break after the turbulence in the Japanese financial markets (the last quarter of 1997), they find that MB sensitivity is consistently higher after the break. This shows that Japanese firms are still sensitive to their MBs during episodes of financial turbulence. Kang and Stulz (2000) find that firms with high dependence on bank financing (higher share of banks in total debt), compared to those with a mere MB relationship, experienced lower stock-price returns and lower level of investment in the first three years of the 1990s, a period of credit contraction in Japan.

Gibson (1997) investigates whether the financial health of the MB (using credit ratings as a proxy) affects the investment behavior of the firm for Japanese during 1994-95. He finds no significant effect, which might be due to the more accommodative lending attitude of financial institutions during the sample period. However, among bank-dependent firms, investment was over 50% lower at firms with the lowest-rated MB. These results contrast a similar study by Gibson (1995), who using data for 1991-92, finds a small effect of poor bank health on corporate investment and no difference between bank-dependent and non-bank-dependent firms.

It has been noted that the various implicit rules related to MBs have failed since the financial crisis. Recently, for instance, MB representation on corporate boards has decreased in spite of the sharp deterioration of corporate performance. This indicates that the insurance function of MBs is weakening. As many banks themselves have been in distress since 1995, they could not prevent their non-financial subsidiaries from going bankrupt either (Economic Planning Agency, 2000).

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[25] In Japan, the Financial System Reform Act of 1993 allows banks to set up securities subsidiaries (and securities firms to set up trust bank subsidiaries). On the basis of their experience as trustees for customers placing corporate bonds in the domestic market and as guarantors or co-underwriters (with Japanese securities houses) for bond issues abroad, Japanese commercial banks were able to penetrate the securities markets within a short period of time.

Restructuring of banks in trouble

Insolvent banks should be restructured in a timely manner in order to restore public confidence in the banking sector. However, bank bankruptcy results in the loss of the relation-specific investment for reputation building and information gathering. Investment can be saved if troubled banks are merged with other banks. In situations where many firms no longer rely on bank credit, investment can also be saved if banks are allowed to underwrite securities. Bank's stakes in the financing needs of their client firms continue even with the new competition with the securities markets (Aoki and Dinç, 1997). If a bank generates substantial non-transferable information through relationship banking, this information capital and the relationship are largely lost if this bank fails. The loss might be much larger than the book value of the bank (Petersen and Rajan, 1994; Berger and Udell, 1995).

5. Relationship Banking after the Crisis in Korea

Even though commercial banks are in a good position to monitor borrowing firms, it has been widely recognized that they have largely neglected the monitoring of their corporate clients in most Asian economies. Relationship banking has been weak in spite of the heavy reliance of major corporations on bank loans in the absence of a well-functioning capital market. After the financial crisis, however, the situation seems to have changed to some extent with the reduction in bureaucratic or political interferences in bank management, and the decrease in the resulting moral hazard that is considered to have been responsible for the crisis. In this section, the results of a questionnaire survey conducted among the officers of large Korean commercial banks are presented. The questionnaires were designed to evaluate whether there has been any progress towards closer bank monitoring of client firms and the practices of relationship banking following the crisis. Also included are opinions on the governance of banks, which are now in the hands of the government, and the desired ownership and governance structure for these banks in the event of privatization.

5.1. Characteristics of Sample Banks and Questionnaire Respondents

The questionnaire study was conducted for the three major commercial banks in Korea. These three banks represent four of the six largest City Banks that existed before the crisis (two of them merged to become Hanvit Bank). All six banks fell into trouble after the crisis, and have undergone a drastic change in their ownership structure as the result of the injection of public funds for recapitalization, mainly by the Korea Deposit Insurance Corporation (KDIC). Of the five banks (following the merger), the study covers only the three largest: Hanvit Bank, Chohung Bank, and Korea Exchange Bank.[26] Unlike the other two, which are mostly owned by the government, Korea Exchange Bank had a large foreign shareholder – Commerzbank (see Table 4). These three banks suffered from a substantial decrease in total assets after the crisis, and streamlined their organizations and

[26] Seoul Bank, one of the most distressed, was excluded from the study as it had been selected by the government for sale to reputable foreign banks. The planned sale was not materialized at the time of the study, but was under a management contract with Deutsche Bank following recapitalization by the government. The other bank, Korea First Bank, was sold to Newbridge Capital, which owns a majority share.

Table 4. Public Fund Injection and Large Shareholders of the Major City Banks

(End of 2000)

Unit: billion won

	Total	KAMCO	KDIC	Major Shareholders & Ownership Share (%)	
Hanvit Bank	83,207	22,921	60,286	Woori Financial Group[2)] (KDIC)	100.00
Chohung Bank[1)]	45,276	18,097	27,179	KDIC	80.05
Korea Exchange Bank	12,190	12,190	0	Commerzbank AG - IAS	32.55
				Export Import Bank of Korea	32.50
				Bank of Korea	10.67
Seoul Bank	77,169	30,360	46,809	KDIC	97.78
Korea First Bank	150,256	30,331	119,945	KFB Newbridge Holdings	50.99
				KDIC	45.92

Notes: 1) Figures include the amounts of public fund injection into Chungbuk Bank and Kangwon Bank, which were absorbed by Chohung Bank in May 1999.
2) Woori Financial Group is a financial holding company wholly owned by the Korea Deposit Insurance Corporation (KDIC) and consisting of Hanvit Bank, three smaller banks, and Hanaro Investment and Merchant Bank (a combination of four previous merchant banks).

Source: Bank Scope; Ministry of Finance and Economy; Korea Asset Management Corporation (KAMCO); Korea Deposit Insurance Corporation (KDIC), *Annual Report 2000.*

Table 5. Size and Performance of Major City Banks

	Total Assets (trillion won)		Number of Branches		Number of Employees		Pre-Provision Operating Profit/Assets (%)		Net Income/Equity (%)		Capital/Risk (%)	
	1997	2000	1997	2000	1997	2000	1997	2000	1997	2000	1997	2000
Hanvit Bank[1)]	96.7	72.4	991	625	17,026	9,944	-	0.16	-	-95.7	-	10.26
Chohung Bank	51.1	51.9	485	463	9,026	6,828	0.57	2.30	-15.7	4.5	6.50	9.78
Korea Exchange Bank	65.4	50.3	400	268	8,705	5,259	0.88	1.84	-2.2	-30.3	6.80	9.19
Seoul Bank	34.4	19.3	357	291	7,524	3,973	-2.57	1.86	-94.3	-65.0	6.40	N.A.
Korea First Bank	37.4	25.9	413	339	7,990	4,597	-2.07	1.05	-162.0	26.8	0.98	13.40

Note: 1) Figures for 1997 are the sum of Hanil Bank and the Commercial Bank of Korea, which merged to become Hanvit Bank in January 1999.
Source: Bank Scope; Financial Supervisory Service, *Financial Statistics*.

personnel to significantly reduce the number of branches and employees. Thanks to these efforts, together with the public fund injection for the purchase of non-performing assets and recapitalization, the banks are now in a much better situation in terms of capital adequacy and operating profits (see Table 5).

Given the nature of the questions, the questionnaires were distributed to bank officers in charge of loan evaluation, managing relationships with corporate clients, setting overall credit policy, and strategic planning. A total of 313 sets of answered questionnaires were collected in early April, 2002. Table 6 shows the characteristics of the respondents including their length of service in the financial sector, age, and position in the bank.

Table 6. Characteristics of the Respondents

	Total	Hanvit	Chohung	KEB
Length of Service in the Financial Industry				
10 years or Under	42	26	11	5
10-20 Years	164	94	39	31
20Years or Over	107	52	11	44
Age				
40 or Under	119	71	27	21
40-50	183	98	34	51
50 or Over	10	2	0	8
Position in the Bank				
Senior Manager or Under	201	115	44	42
Deputy General Manager	75	32	16	27
General Manager or Over	33	21	1	11
Total Number of Respondents	313	172 [1]	61	80

Note: In the case of Hanvit Bank, four respondents did not give their position, and one of them did not give his age, either.

5.2. Results of the Questionnaire Survey

For most of the questions, the respondents were asked to express the extent to which they agreed or disagreed with a given statement. They were asked to choose from five items to indicate their opinions: {3 - strongly agree; 2 - agree; 1 - weakly agree; 0 - neither agree nor disagree (or no opinion); N – disagree}. For the purpose of calculating the average score of opinions for all the respondents, N was given a numerical value of –2 in order to maintain symmetry between "agree" and "disagree."

Intensity of bank monitoring

Korean banks are generally known to have neglected the monitoring of their corporate clients, and that this was responsible for the failure of several *chaebols* that triggered the Korean crisis in late 1997. As background for evaluating the bank-business relationship, it would be helpful to evaluate the major reasons for this negligence and whether the situation has improved after the crisis. Many of Korea's large business firms are owned and controlled (and managed) by a family, exposing them to potentially serious agency problems between the controlling and outside (minority) shareholders. It is in these firms that proper corporate governance is most needed. The results of the questionnaire survey on bank monitoring are summarized in Box 2.

1. Are banks making increased efforts to monitor borrower companies?

The respondents generally believe that banks have increased their effort to monitor client firms. Among the three different types of monitoring by stage, the respondents indicate that banks have increased *ex ante* monitoring (screening loan application) more than *interim* monitoring (after loans are made) or *ex post* monitoring (corporate restructuring in the event of financial distress). Given that what distinguishes relationship banks from other banks is *interim* and *ex ante* monitoring, this results seem to indicate that relationship banking is not yet prevalent in Korea.

2. What is the most important factor behind these enhanced monitoring efforts by banks?

Stronger monitoring is most strongly motivated by the higher risk of corporate default as well as increased concern about the future of banks themselves. These concerns seem to result from a new perception that the government no longer stands ready to rescue distressed business groups or banks. Strengthened prudential regulations and better information on corporate clients often newly acquired in the process of corporate restructuring following the crisis have also contributed to the enhanced monitoring. However, the strengthened bargaining power of banks vis-à-vis corporate clients and banks' corporate ownership resulting from a debt-equity swap (often arranged as part of corporate debt restructuring), turn out to be relatively less important. It seems that equity ownership by creditor banks, as a means of cementing the relationship between a bank and its client firms, is not generally recognized, or that banks have no intention to be stable shareholders of the firms.

3. What factors have strengthened banks' bargaining power vis-à-vis their large corporate clients after the crisis?

Even though stronger bargaining power of banks is known to be far from an important factor behind better monitoring, it seems true that their bargaining power has actually been strengthened. More important contributing factors include reduced expectations of government bailouts of distressed firms (which might have been considered to be too big to fail before the crisis), better information about corporate clients, and reduced forbearance of bank managers. It is somewhat surprising that the weaker economic power of business groups or reduced interference by bureaucrats and politicians turn out to be relatively unimportant. In spite of the bankruptcy of some business groups, banks do not appear to have much stronger bargaining power over the surviving groups. Also, bureaucrats and politicians seem to continue to interfere in banking operations, something that may be inevitable given that the sample banks are now owned and controlled by the government.

4. *What have been the most important factors constraining the closer monitoring of borrowing corporations?*

There seem to be no major constraint in the monitoring activities of banks. Constraints with some importance include unreliable corporate financial statements, weak incentives for bank officers to do close monitoring, the weak bargaining power of banks vis-à-vis borrowing firms, and the poor system of managing client information (due to the high turnover of loan officers, shortage of manpower, etc). Inadequate expertise for bank officers or weak incentives for top managers do not seem to pose a constraint for the monitoring activity of banks.

5. *What are the most important reasons for the weak incentives for monitoring on the part of bank officers?*

Even though bank officers seem to have insufficient incentives to closely monitor their client firms, it is not clear what makes these incentives inadequate. Respondents weakly agree that rewards for good monitoring and penalties for the neglect of monitoring are not very strong. However, monitoring activities do not seem to be much discouraged by the securing of collateral or the dictation of loan decisions by supervisors without much regard to screening or monitoring. Furthermore, bank officers tend to disagree to the claim that monitoring doesn't matter much since some clients are "too big to fail."

6. *How important is the role of banks in overseeing corporate management in comparison to that of other stakeholders?*

Whom do corporate managers fear most, or whose interests are corporate managers most willing to accommodate? There is general consensus that corporate managers pay the keenest attention to the interests of the controlling owners in normal times. The second focus of attention is creditor banks, and the third the workers or labor unions. In large corporations, however, workers or labor unions are nearly as important as creditor banks. The least important is the interests of non-controlling shareholders. In times of financial times, however, the voice of creditor banks becomes stronger than that of the controlling owners, and more so for small and medium-sized firms.

Box 2. Opinions on Bank Monitoring

1. Are banks making increased efforts to monitor borrower companies?

- More serious screening of loan applications [2.31]
- Closer monitoring of the borrowers after making loans [1.96]
- More active role in corporate restructuring in the event of financial distress in borrowing firms [1.61]

2. [If you answered yes on any of the items above] What is the most important factor that has motivated these enhanced efforts of monitoring by banks?

- Higher risk of corporate default (including no more "too-big-to-fail" perception toward the *chaebols*) [2.39]
- Increased concern about the survival or growth of banks; lower chance of government bail-outs of troubled banks [2.29]
- Strengthened prudential regulations on credit risk management imposed either internally or by the financial supervisory authorities [1.71]
- Better information on corporate clients (accumulated in the process of corporate restructuring after the crisis), which serves as a basis for continuing monitoring [1.62]
- Debt-equity swap (as the result of workouts) that has made banks not only creditors but also shareholders of the borrowing firms [1.32]
- Strengthened bargaining power of banks vis-à-vis their corporate clients [0.71]

3. To what extent, do you agree with these factors as causes for the strengthening of banks' bargaining power vis-à-vis their large corporate clients after the crisis?

- No firms are "too big to fail" (little expectation of government bailouts) [1.85]
- Much more information about corporate clients accumulated to monitor them [1.84]
- Forbearance of bank managers (poor governance of banks) no longer allowed [1.52]
- Reduced interference by bureaucrats and politicians in banking operations [1.14]
- The economic power of large *chaebols* has been weakened and their management has been more decentralized [1.14]

4. What have been the most important factors constraining closer monitoring of borrowing corporations?

- Weak incentives for bank officers to closely monitor [1.43]
- Difficulty in monitoring on the basis of corporate financial statements due to the lack of transparency [1.40]
- Difficulty in monitoring due to banks' still weak bargaining power vis-à-vis borrowing firms (making information acquisition difficult) [1.33]
- Poor system of managing client information due to the high turnover of loan officers, shortage of manpower, etc. [1.06]
- Weak incentives for top bank managers: bank performance may not be the determining factor in the CEO's objective functions [0.13]
- Inadequate expertise of bank officers in charge of monitoring [0.11]

5. What are the most important reasons for the weak incentives for monitoring on the part of bank (loan) officers?

- Inadequate incentives for good monitoring or weak penalties for the neglect of monitoring [0.72]
- Loan decisions dictated by supervisors (often under the bureaucratic or political pressure) without much regard to screening/monitoring [0.18]
- Securing of collateral [0.16]
- Some clients considered to be "too big to fail" [-0.41]

6. How important is the role of banks in overseeing corporate management in comparison to that of other stakeholders? In other words, whom do corporate managers fear the most (among controlling shareholders, outside shareholders, employees, and banks)?

<1, 2, 3, 4 by order of importance>

	Large Corporations		SMEs	
	Normal Times	In Times of Financial Distress	Normal Times	In Times of Financial Distress
Controlling Owners	1 (1.12)	2 (1.75)	1 (1.24)	2 (1.84)
Other Shareholders	4 (3.22)	4 (3.44)	4 (3.32)	4 (3.43)
Creditor Banks	2 (2.82)	1 (1.55)	2 (2.36)	1 (1.45)
Workers or Labor Unions	3 (2.84)	3 (3.26)	3 (3.08)	3 (3.27)

Relationship banking

It is not clear to what extent Korean banks have maintained a close long-term relationship with their corporate clients. Even though a "principal transactions bank" has long been designated for each of the large *chaebols*, it was largely imposed as a regulatory superstructure rather than as an autonomous relationship. With the increased need for the monitoring of corporate clients and other changes in the business environment (for both banks and other corporations), it is of great interest to see whether "relationship banking" is emerging in Korea after the crisis. Presented in Box 3 is a set of questions on relationship banking and the summary responses to these questions.

1. *Is there any trend toward, or greater awareness of, a more stable long-term relationship between banks and their borrowing firms?*

There seems to be greater awareness of the importance of relationship banking among bank officers. Moreover, most of the respondents who report such awareness also tend to think that some progress has been made toward relationship banking.

2. *What are the most important factors behind the progress toward relationship banking?*

Several factors have been instrumental in fostering relationship banking, though no single one seems to stand out. The more important factors include higher corporate risk perceived by both banks and their clients, more focused marketing strategies of banks with operational divisions specializing in a particular type of clients, and better information on corporate clients. Other contributing factors include debt-equity swaps (making the creditor bank a substantial shareholder of its client company), accumulated information and experience as the "principal transactions bank" of client firms, the strengthening of the bargaining power of banks, and less outside interference in lending decisions. The lower importance of bank bargaining power, outside interference, and debt-equity swaps seem to be consistent with the findings on monitoring presented before.

3. *What are the most important motivations or expected benefits for having such a relationship for borrowing firms?*

The most important benefits of relationship banking for borrowing firms as seen by bank officers include advice from bankers on overall business and financial strategies, easy access to other financial markets, reduced costs in times of financial distress, and better credit availability. However, bank officers do not appear to be very convinced about the benefits, since their scores are generally low. Even less recognized benefits are risk sharing or the mitigation of liquidity constraints by relationship banks.

4. *What are the most important motivations or expected benefits for having such a relationship for creditor banks?*

Bank officers seem to better appreciate the benefits of relationship banking for creditor banks. They tend to believe that relationship banking allows them to better monitor borrowing firms, secure a customer base for a lucrative banking business, and ensure timely management intervention and control in times of performance deterioration. However, the respondents seem less convinced of the potential extraction of "monopoly rents" by a relationship bank from the informational monopoly over its client firms.

5. *What factors may make borrowing firms reluctant to develop such a relationship?*

The declining corporate dependence on bank loans among more creditworthy corporations stands out among the factors constraining the development of relationship banking. Other constraints include the high turnover of bank officers in charge of managing the relationship with particular corporate clients, the reluctance of firms to reveal sensitive corporate information to the bank, and inadequate expertise offered by banks to meet corporate demand for diverse financial services. Among the less important factors are the discouragement by banks of risky but promising investment projects, the possibility of being informationally captured by the bank, concern about banks' excessive monitoring and management intervention, and the higher perceived risk of banks' own distress.

6. What factors may make creditor banks reluctant to develop such relationships?

Declining corporate dependence on bank loans is the most important deterrent to relationship banking on the part of banks as well. Other factors include keener competition in the financial markets, expected difficulties in making timely and rational decisions when client firms are in financial distress, and increased costs of maintaining relationship banking in times of economy-wide financial turbulence.

7. *For which type of firms will relationship banking be most beneficial form the standpoint of banks and firms?*

From the standpoint of creditor banks, relationship banking is believed to be most beneficial with promising small and medium-sized firms, followed by that with large and creditworthy firms, large but less creditworthy firms, and less promising SMEs. From the standpoint of client firms, both large but less creditworthy firms and promising SMEs are viewed as benefiting the most from relationship banking, while large and creditworthy firms benefit the least.

8. *What specific actions of a bank will help build strong relationship banking with its clients?*

Avoiding frequent changes in bank officers in charge of managing the relationship with particular clients is seen as the most important in fostering relationship banking. Close consultations with the bank on major corporate decisions and concentrating the use of banking services on one or a few banks are also viewed as instrumental. Actions that are viewed as somewhat less important include banks' holdings of the equity shares of corporate clients and dispatching personnel to the corporate boards.

9. *What effects can be expected from a bank's holding of equity shares in its client firms?*

The respondents seem to believe that a bank's holdings of both loans and equity shares in corporate clients will strengthen its monitoring incentives, reduce conflicts of interest between the bank and corporate shareholders, and prevent the premature liquidation of solvent firms. Potential negative effects such as the higher chance of undertaking unprofitable investments (due to eased liquidity constraints) and the exertion of stronger influence on the firms for banks' own interests seem to be less recognized by bank officers.

10. *Will the relationship of "principal transactions bank" or "main creditor bank" evolve naturally into an autonomous relationship banking for the client firms?*[27]

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[27] The system of "principal transactions banks (PTBs)" started as a part of a credit control device on large business groups in the mid-1970s. As the capital structure of large business firms became increasingly fragile with the heavy burden of debt, the Korean government attempted to correct the situation by controlling bank loans to business groups while encouraging them to turn to the capital market for financing. The PTBs were given the task of implementing credit control and improving the capital structure of major borrowers by keeping an eye on the financial and business situations of the client firms and business groups. The system of PTBs has undergone some changes in its scope and in the roles of the banks. In later years, for instance, the PTBs were entrusted by the financial supervisory authorities with restricting the debt-financed acquisition of "non-productive" real estate or investment in other companies.

The emphasis of the system is now on reducing credit concentration on large corporations and improving the capital structure of heavily-indebted business groups, thereby enhancing the soundness of the asset portfolio of financial institutions. In addition to managing credit and business information on large business groups and their affiliates and providing managerial guidance for the improvement of their capital structure, the "main creditor banks" (MCBs – the new name for the PTBs) organize a creditor bank consultation committee and work out and implement corporate restructuring measures with the help of other creditor banks when a client firm is in serious financial distress. Although the functions of PTBs or MCBs appear similar to those of main banks in Japan, there seems to be a distinct difference. The system was superimposed by the government with certain policy objectives and has failed to foster an autonomous

The expectation that this seemingly similar bank – business (group) relationship will evolve into more autonomous relationship banking seems to be rather weak. It may reflect the fact that the system, imposed by the financial supervisory authorities, has not been very successful in reducing information asymmetry and building reputation on the part of the banks. Given that the bank-business relationship has been imposed only on business groups and their subsidiaries, and that such firms tend to be less dependent on bank loans, the room for this system to evolve into autonomous relationship banking seems to be limited.

11. How does a creditor bank typically react when a medium-sized borrowing firm falls into financial distress (from which the firm, although considered solvent, may not get out in the short run), and asks for an additional loan?

The intent of this question was to evaluate the extent to which the response of banks is consistent with relationship banking. The respondents most strongly support the bank action of providing loan that are conditional on necessary restructuring efforts. Though this response is consistent with what is expected from a relationship bank, the respondents do not seem to be very convinced of the action. Other responses with a slightly lower support level include providing credit while adjusting the terms to reflect the increased risk or sending a bank officer to the firm for better monitoring, and urging the firm to look for other financial sources. The bank may liquidate the firm if most of the existing loans to it can be recovered. This behavior, however, has little support among the respondents. Overall, some of the bank responses are consistent with those of relationship banking, while others are not, and are probably typical of a less-committed relationship bank.

Box 3. Opinions on Relationship Banking

1. **Is there any trend toward, or greater awareness of, a more stable long-term relationship between banks and their borrowing firms?**
   - Yes, there is greater awareness [1.96]
   - Yes, there is both such awareness and actual progress. [1.81]
2. **[If you answered yes to any of the items above] What are the most important factors that have contributed to the progress toward relationship banking?**
   - Perception of a higher risk of corporate financial distress or default among both banks and their clients after the crisis [1.65]
   - More focused marketing strategy by banks where their operational divisions specialize in a particular type of client [1.59]
   - Better information on corporate clients accumulated in the process of corporate restructuring after the crisis, which serves as a basis for continuing monitoring [1.46]
   - Debt-equity swap (as a result of workouts) that has made banks not only creditors but also shareholders of the borrowing firms [1.37]

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relationship of mutual commitment. As such, the bank monitoring of client firms has tended to remain superficial with the major attention given to the compliance with government regulations (Nam, 1994).

- Accumulated information and experience as the Principal Transactions Bank of *chaebols* [1.36]
- Strengthened bargaining power of banks vis-à-vis their clients after the crisis [1.33]
- Less outside (bureaucratic or political) interference in lending decisions [1.16]

3. What are the most important motivations (expected benefits) for having such a relationship for borrowing firms?

- Advice from the bank on overall business and financial strategies [1.18]
- Easier access to other financial markets: to get help from banks beyond borrowing with securities issues and other services in accordance with the progress toward universal banking [1.14]
- Reduced costs of financial distress: to avoid premature liquidation or otherwise reduce the costs of corporate restructuring in the event of severe financial distress [1.06]
- Better credit availability (increased debt capacity due to reduced information asymmetries) [1.03]
- Mitigation of liquidity constraints: to mitigate any shortage of liquidity (investments less constrained by own cash flow) or temporary financial difficulties [0.78]
- Risk sharing: to have business risk shared with banks (e.g., lower interest charges during periods of poor corporate performance) [0.49]

4. What are the most important motivations (expected benefits) for having such a relationship for creditor banks?

- To better monitor borrowing firms – business and financial conditions, prospects, management quality, etc. [1.78]
- To secure a customer base from lucrative banking services [1.74]
- To ensure timely management intervention and control in the event of performance deterioration [1.62]
- To extract "monopoly rents" (higher average interest rates over the long period of relationships) from exclusive power over the financial affairs of borrowing firms [0.84]

5. What factors may make borrowing firms reluctant to develop such a relationship?

- Declining corporate dependence on bank loans among more creditworthy corporations [1.93]
- High turnover of bank officers in charge of managing the relationship with a particular corporate client [1.38]
- Reluctance to reveal sensitive corporate information to the bank [1.37]
- Inadequate expertise of bank officers to meet corporate demand for diverse financial services [1.33]
- Banks' discouragement of risky (but promising) investment projects [1.11]
- Possibility of being stuck to a bank in the face of increasing competition among banks (forgoing better quality or lower fees and interest rates offered by other banks) [0.98]
- Anticipated increase in banks' monitoring and management intervention or control (in times of poor corporate performance) [0.75]
- Higher perceived risk of banks' own distress (reducing the value of a stable long-term relationship) [0.39]

6. What factors may make creditor banks reluctant to develop such a relationship?

- Declining corporate dependence on bank loans [1.66]
- Keener competition in the financial markets (making it difficult to maintain such a relationship or to extract any benefits from such a relationship) [1.52]
- Concern that such a relationship would make it difficult to make timely and rational decisions in times of corporate distress (soft-budget problem) [1.22]
- Increasing costs of maintaining such a relationship – the burdens of providing distress financing and other supports of corporate restructuring in times of economy-wide financial turbulence [1.03]

7. For which type of firms will relationship banking be most beneficial, from the standpoint of banks and firms?

<1,2,3,4 by the order of largest benefit>

	From the Standpoint of Banks	From the Standpoint of Client Firms
Large, Creditworthy Firms	2 (2.43)	4 (3.14)
Large, Less Creditworthy Firms	3 (2.93)	1 (2.12)
Promising SMEs	1 (1.56)	2 (2.13)
Other SMEs	4 (3.07)	3 (2.60)

8. What specific actions by banks will help build strong relationship banking with their clients?

- Avoiding frequent changes of bank officers in charge of managing the relationship with a particular client [1.82]
- Consulting with the bank on major corporate managerial decisions [1.63]
- Concentrating the use of banking services including borrowings, deposits and foreign exchange transactions into a few banks [1.62]
- The bank's holding equity shares of its corporate clients [1.04]
- The bank's dispatching managers as outside directors on the boards of its client firms [0.93]

9. What effects can be expected from a bank holding equity shares in its client firms?

- The bank's monitoring incentives will be strengthened. [1.63]
- Conflicts of interest between the bank (creditor) and the corporate shareholders will be lowered. [1.30]
- Premature liquidation of solvent firms will be avoided. [1.27]
- With the reduced liquidity constraints, the chance of undertaking unprofitable investments will be higher. [0.83]
- The bank will exert a stronger influence on the firms for its own interests such as higher interest charges or favoring of low-risk projects. [0.61]

10. Will the relationship of Principal Transactions Bank (Main Creditor Bank) evolve naturally into an autonomous relationship banking for the client firms?

- It will. [1.21]
- Such a relationship has already been developed to a substantial degree. [1.02]

11. When a medium-sized borrowing firm falls into financial distress (from which the firm, although considered solvent, may not escape in the short run), and asks for an additional loan, how does the creditor bank typically react?

- Accommodates the firm's needs on the condition that it undertakes structural adjustments, including downsizing, business streamlining, and asset disposal [1.42]
- Extends additional credit, but adjusts the loan rate or asks for additional collateral reflecting the increased risk [1.18]
- Does not extend additional credit, and urges the firm to look for other financing sources [1.12]
- While accommodating the firm's needs, sends an outside director/auditor, or dispatches a manager to closely monitor the firm [1.10]
- Liquidates the firm if most of the existing loans can be recovered [0.35]

Governance of banks

With the recapitalization of troubled banks by the government, many banks are now in the hands of the government. As the controlling shareholder of these banks, the government may intervene in their operations and may be negligent in supervising the bank management. While these banks will be privatized in the near future, questions remain about the desired ownership structure for the privatized banks in terms of efficiency as well as the avoidance of serious conflicts of interest. Box 4 shows the perception of bank officers on these questions.

1. What are the most important factors behind the weak discipline in bank management?

There seems to be a fairly strong belief that government ownership of banks and political or bureaucratic interference in banking operation will weaken the accountability of managers for bank performance. Somewhat less important factors include the virtual absence of hostile takeovers of banks and diffused ownership (of other banks). The moral hazard for banks due to deposit insurance or the expectation of government bailout of troubled banks turns out to have little to do with the weak discipline of bank management. Respondents do not seem to believe that the weak discipline is due to the neglect of duties by the financial supervisory authorities or banks' creditors, or by an oligopolistic banking market structure.

2. Will the government ownership of commercial banks seriously constrain the efficiency of banks? If so, why?

The respondents believe that government banks are inefficient because outside interference in bank management constrains management initiatives, the appointment or dismissal of senior managers is not strictly based on their capability or performance, and incentives for monitoring bank management are weak. Relatively unimportant factors include the belief that the government will not allow banks to go bankrupt, and the absence of pressure from the stock market. It seems remarkable that bank officers do not suffer from complacency, which is likely to reflect the uncertain future for some of the banks that have only survived due to the recapitalization by the government.

3. *Will large chaebols be allowed to own and control major commercial banks?*

The respondents did not seem to have a strong opinion on this issue. The negative view is slightly stronger than even the cautious permissive view that *chaebols* may gradually be allowed to own banks with institutional safeguards against possible side effects.[28] The opinion that *chaebol* ownership is better for a bank than having no controlling owners or remaining a government bank is weakly supported. A view with even weaker support is that *chaebols* may be allowed to own a bank with strengthened prudential regulation.

4. *What are likely to be the most serious problems with banks owned and controlled by chaebols?*

The respondents show rather serious concerns about a wide range of potential problems that might arise with *chaebol*-controlled banks: these banks may abuse the market power of their group to promote their banking business; may discriminate against competitors of their group, and may have larger scope for abusing conflicts of interests (due to their diversified businesses). Other concerns associated with *chaebol*-controlled banks include bank instability, larger room for moral hazard, lower managerial efficiency, and excessive favor to *chaebols*.

5. *What would be the most important advantages of chaebol-ownership of banks?*

The respondents are not very convinced of the benefits of *chaebol*-controlled banks. Even the most important benefit of such banks has a lower support level than the least important concern. Relatively important benefits include higher efficiency due to strong monitoring and supervision incentives by the controlling owners, better attention on share value maximization, and higher efficiency resulting from economies of business scope. The view that *chaebol*-controlled banks might be more stable, better serving their affiliated firms, and more reliable turns out to be not much supported.

6. *What ownership and governance structure might be most desirable for the government-owned banks that are to be privatized?*

The most preferred controlling owners turn out to be financial groups without non-financial businesses, which is understandable given such benefits as the small room for conflicts of interests, economies of scope, and strong monitoring incentives. The least preferred owners are foreign financial institutions and *chaebols*. The objection to foreign financial institutions might, to some extent, reflect concern about job security. Interestingly, the second most preferred choice is joint ownership and control by a *chaebol*

[28] In the case of nationwide city banks in Korea, the maximum ownership share for any individual, corporation, or business group has been set at 4%, effectively preventing large business groups from controlling banks. The consequent diffuse ownership structure, which lacks large shareholders, resulted in a situation of governance vacuum, providing fertile soil for government interference in the management of private banks. The poor governance in these banks may have significantly contributed to the inefficient management of banks and the deterioration of their asset portfolios.

and a foreign financial institution (though they are least preferred as sole controlling owners). The next preference is for widely-held ownership. However, among widely-held banks, those controlled by public institutional investors and, to a less extent, by private institutional investors are preferred to those without any controlling institutional investors.

Box 4. Opinions on Bank Governance

1. What are the most important factors behind the weak discipline in bank management?

- Government ownership of banks and political/bureaucratic interference in banking operation [1.58]
- Inactive market for hostile takeovers of banks [0.88]
- Diffuse ownership: no large private shareholders with a strong interest in monitoring [0.79]
- Banks' moral hazard: deposit insurance and expectation of government bailouts of banks in distress [0.37]
- Oligopolistic market structure of the banking industry [-0.05]
- Duties neglected by other monitors of banks such as the financial supervisory authorities or banks' creditors [-0.30]

2. Will the government ownership of commercial banks seriously constrain the efficiency of the banks?

- Government/political interference in bank management will constrain banks' initiatives for capability enhancement [1.81]
- Appointment/dismissal of senior managers is not strictly based on their capability or performance, constraining autonomous bank management [1.80]
- Weak monitoring incentives: little personal stake for those supervising the management [1.45]
- No pressure from the stock market as the equity shares are not traded in the market [0.89]
- Complacency that the government will not let the banks go bankrupt [0.32]

3. Should large *chaebols* be allowed to own and control major commercial banks?

- No [1.36]
- Yes, but only gradually in order to prepare for possible side effects or shocks in the market [1.05]
- It is better than "banks with no owner" [0.74]
- It is better than having them remain as government banks [0.74]
- Yes, with strengthened prudential regulation [0.51]

4. What are likely to be the most serious problems?

- Bank-owning *chaebols* may abuse their market power (in non-banking services and industrial products) to promote their own banking business (e.g, through tied-in sales) [1.83]
- *Chaebol*-controlled banks might discriminate against the competitors of their *chaebol* in the provision of bank services including information (in the imperfect financial market) [1.82]

- Larger scope for abusing conflicts of interest (e.g, the abuses expected in a universal bank) [1.82]
- They may be less stable (than stand-alone banks) due to the association with *chaebols* [1.67]
- Larger room for moral hazard (such as lending to insolvent subsidiaries) in expectation of a government bailout of their bank [1.58]
- Lower managerial efficiency due to higher dependence on (less capable) family management [1.47]
- It favors *chaebols* since the entry into, and competition in, banking is restricted (contributing to further concentration of economic power, and increasing the possibility of having government policies distorted by them) [1.44]

5. What would be the most important advantages of *chaebol* ownership of banks?

- More efficient due to stronger monitoring/supervision incentives of the large owners [1.34]
- Higher priority given to maximizing the value of equity shares [1.32]
- More efficient due to economies of scope [1.30]
- More stable due to the size and diversified nature of *chaebols* [0.62]
- Timely support of their *chaebol* subsidiaries in temporary financial distress, and protecting firms with a subcontract relationship or other customers [0.62]
- More reliable (refraining from abusing conflicts of interest) since (diversified) *chaebols* may be more concerned about their reputation [0.54]

6. What ownership and governance structure is most desirable for the government-owned banks that are to be privatized ? (1, 2, 3, · · ·, 7 by order of preference)

- Owned and controlled by *chaebols* specializing in financial services only [2.45]
- Jointly owned and controlled by *chaebols* and foreign financial institutions [3.75]
- Widely-held, but controlled by public institutional investors (such as the National Pension Fund) [3.90]
- Widely-held, but controlled by private institutional investors (many of which are owned by *chaebols*) [4.09]
- Widely-held without any controlling owners or institutional investors [4.33]
- Owned and controlled by *chaebols* [4.95]
- Owned and controlled by reputable foreign financial institutions [4.97]

Are there any differences between more and less experienced bank officers?

Bank officers form their perceptions on the monitoring of client firms, relationship banking and bank governance through their experience at work. As such, their perceptions are influenced by the norms and practices they have acquired throughout their careers in relevant fields. When they are exposed to new business environment and norms (such as those after the financial crisis) they may look at the changes in a more sensitive way (either positively or negatively), or may react to the new rules in defence of old ways of doing business. Table 7 shows the questions for which more experienced officers (working in the financial sector for 20 years or more) or more highly positioned officers (deputy general managers or over) responded rather differently from others.

Bank monitoring of client firms. Higher-level and more experienced officers tend to more strongly believe that the lack of transparency in corporate financial statement and the poor system of managing client information (with the high turnover of loan officers and shortage of manpower) have been the factors constraining closer monitoring of client firms. They also believe that the bargaining power of banks vis-à-vis borrowing firms has been strengthened (though it is still weak) by reduced interference by bureaucrats or politicians, as well as by the less serious problem of forbearance by bank managers. They, however, react negatively to the claim that the dictation of loan decisions by supervisors has weakened monitoring incentives.

Relationship banking. Experienced or high-position bank officers believe more strongly than others that less interference by bureaucrats or politicians in lending decisions is an important factor in fostering relationship banking. Nevertheless, they are far less convinced about what can be expected from relationship banking (either benefits or concerns) including having banks hold equity shares of client firms. This perception may reflect the fact that they are accustomed to making loans under the direction of the government or supervisors, with little attention given to relationship management. They also tend to more strongly feel that declining corporate dependence on bank borrowing discourages relationship banking while concentrating a firm's banking services on one or a few banks helps relationship banking.

Bank governance. More experienced or higher-positioned bank officers tend to put less blame on government ownership/intervention or diffused ownership for the weak discipline in bank management. They are generally less convinced of the inefficiency of government-owned banks due to bureaucratic/political interference in bank management, political appointment/dismissal of bank senior managers, and weak monitoring incentives. More experienced officers also look more favorably at the potential advantages of *chaebol*-controlled banks, though they are more concerned about the potential problem that these banks might discriminate against business firms that compete with their subsidiaries and other affiliated companies.

Table 7. Areas Where More Experienced Officers Have Different Opinions

	Average	Less Experienced	More Experienced
Bank monitoring of client firms			
Reasons for banks' stronger bargaining power			
- No more forbearance of bank managers	1.52	1.45	1.67 (1.69)**
- Reduced interference by bureaucrats/politicians	1.14**	0.99	1.41 (1.31)*
Factors constraining closer monitoring by banks			
- Lack of transparency in financial statements	1.40	1.33	1.54 (1.59)**
- Banks' weak bargaining power	1.33	1.28	1.42 (1.50)*
- Poor system of managing client information	1.06**	0.90	1.36 (1.22)
Loan decisions dictated by supervisors -> weakening monitoring incentives	0.18**	0.34	-0.11 (-0.27)**

Relationship banking			
Less outside interferences in lending decisions -> increasing bank interest in relationship banking	1.16**	1.06	1.34 (1.32)**
Mitigation of liquidity constraints as a potential benefit of relationship banking	0.78	0.85	0.64 (0.59)**
Declining corporate dependence on bank loans making banks reluctant to invest in relationships	1.66**	1.57	1.84 (1.72)
Concentration of banking services on a limited number of banks important for relationship banking	1.62	1.55	1.75 (1.79)**
Expected effects of bank's holding equity shares of client firms			
- Conflicts of interest between bank and corporate shareholders reduced	1.30**	1.41	1.08 (1.21)
- Premature liquidation avoided	1.27	1.33	1.14 (1.07)*
- Higher chance for unproductive investments	0.83**	0.97	0.58 (0.62)*
- Banks interests better pursued	0.61**	0.82	0.21 (0.26)**
The system of PTBs will evolve naturally into an autonomous relationship banking	1.21*	1.31	1.03 (1.18)
Bank governance			
Factors behind weak discipline in bank management			
- Government ownership / management intervention	1.58**	1.76	1.24 (1.22)**
- Diffused ownership	0.79	0.86	0.66 (0.54)**
Why government ownership might constrain bank efficiency?			
- Government/political interference in management	1.81**	1.90	1.63 (1.73)
- Political appointment of senior managers	1.80	1.84	1.72 (1.58)**
- Weak monitoring incentives	1.45	1.50	1.36 (1.17)**
- Absence of pressure from the stock market	0.89*	0.99	0.69 (0.77)
- Complacency as government banks	0.32*	0.43	0.10 (0.18)
Discrimination against *chaebol* competitors as a potential problem with *chaebol*-controlled banks	1.82**	1.73	2.00 (1.79)
Potential advantages of *chaebol*-controlled banks			
- More efficient due to stronger monitoring/supervision	1.34*	1.25	1.51 (1.36)
- More attention to shareholder value	1.32**	1.22	1.53 (1.49)

Notes: Numbers in parentheses are scores for respondents whose position is deputy general manager or higher. ** and * indicate that the coefficients are statistically different between the two samples in comparison (less experienced vs. more experienced; and lower vs. higher positions) at the 5% and 10% significance level, respectively.

Are there differences among banks?

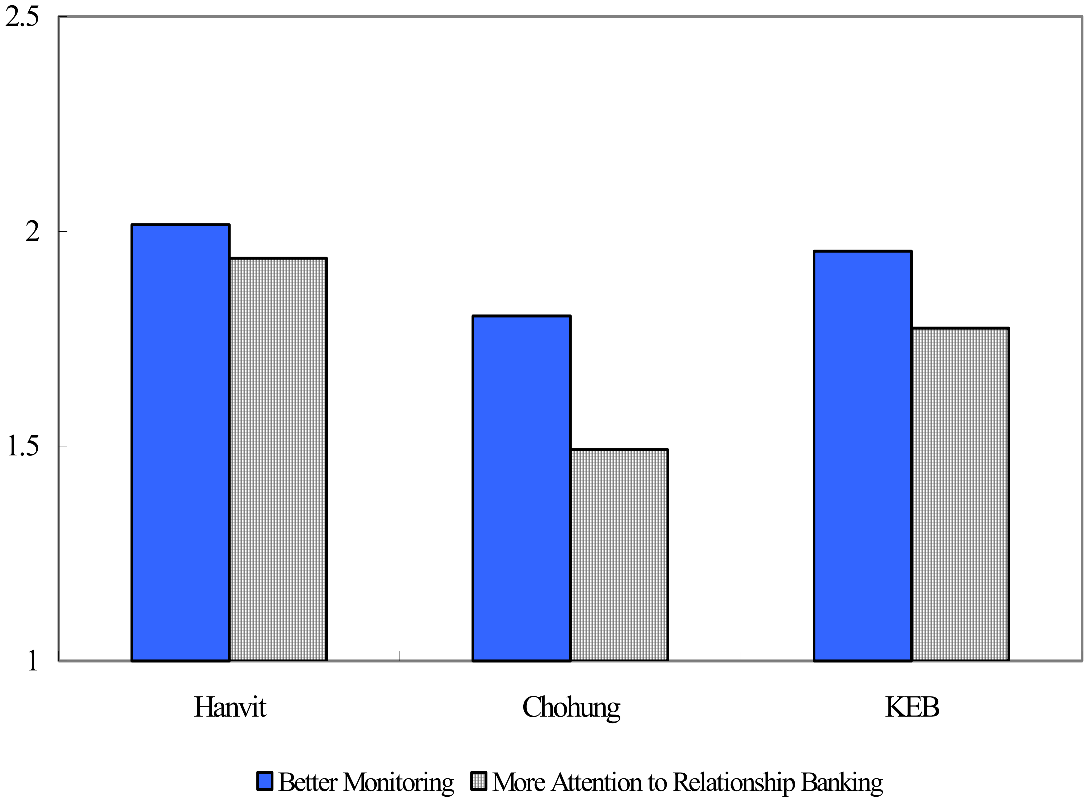
It would be interesting to see whether the responses to some of the questions are significantly different among banks. The three sample banks have common characteristics: substantial public funds have been injected following the financial crisis through the Korea Asset Management Corporation, Korea Deposit Insurance Corporation, and other government banks resulting in a controlling share being held the government. As the major city banks, their business and customer bases are similar, with heavy exposure to large business firms. Nevertheless, there are some differences between them as well in the ways and degree of restructuring after the crisis. Hanvit Bank, which was created as a merger of two major city banks, underwent the most severe restructuring. During the three-year period until the end of 2000, its assets declined from 97 trillion won to 72 trillion won; branch offices were reduced from 991 to 625; and the number of employees dropped from 17,000 to less than 10,000. Korea Exchange Bank underwent almost the same degree of restructuring, with a German bank (Commerzbank) participating in management as a major shareholder. Chohung Bank, however, has been least affected among the city banks: during the three years until the end of 2000, there were almost no changes in the size of its total assets and number of branches, even though there was a substantial reduction in the size of its staff (see Tables 4 and 5).

Monitoring efforts and relationship banking after the financial crisis. The results of the self-assessments by bank officers of their monitoring and relationship banking practices are presented in Figure 1. The figure shows that Hanvit Bank officers believe most strongly that their monitoring of client firms and relationship banking practices have been strengthened after the financial crisis. Chohung Bank scores the lowest among the three, which may be explained by the fact that the bank's restructuring was relatively less painful. As the result, the urgency for changing old ways of doing business might have not been as great as in the other banks.

Perceptions on government ownership or intervention and its impact on bank efficiency. Officers from different banks may have somewhat different views about government ownership or intervention, depending on their bank-specific experience. Table 8 presents regression results on the responses to various questions related to government ownership and intervention in banking, explained by the length of service for the respondent and bank dummy variables. Consistent with the evidence presented above, more experienced bank officers tend to see the environmental changes (reduced bureaucratic/political interference, bank manager forbearance, and expectation of bailouts) as more significant. Chohung Bank officers seem less assured of better monitoring or stronger bargaining power resulting from reduced government involvement in corporate bailouts. The officers of Chohung Bank and KEB share (more strongly than Hanvit officers) the view that bank monitoring is constrained by the weak interest of CEOs whose evaluation are not strictly based on bank performance, and that government-owned banks are likely to be inefficient due to associated complacency.

Perceptions on chaebol ownership of banks. The government equity shares in the sample banks are scheduled to be divested in the future, and bank officers may have their own views on the desirability of *chaebol* ownership of banks. The responses regarding *chaebol*-owned banks, together with their potential problems and advantages, show that Chohung

Figure 1. Monitoring and Relationship Banking: Self-Assessment by Bank Officers



Notes: Better monitoring: average score on the three types of monitoring under the question "Have their been increased efforts to monitor borrower companies by banks?" More attention to relationship banking: average score on the response "Yes, there is both such awareness and actual progress" to the question "Is there any trend toward, or greater awareness of, a more stable long-term relationship between banks and their borrowing firms?"

Bank officers least object to the idea of such banks, followed by Hanvit Bank. The unfavorable perception of KEB officers toward *chaebol* ownership might partly be explained by the bank's culture, originating from the late 1960s, when the bank started as a specialized bank with the central bank as its major shareholder. The difference in perception between Hanvit and Chohung Bank officers is also understandable given that Havit is larger and has formed a financial group (Woori) comprising other smaller banks and non-bank financial institutions. Given the not-very-favorable public sentiment toward *chaebols*, it would be difficult to justify a *chaebol* taking over a large financial group (see Figure 2).

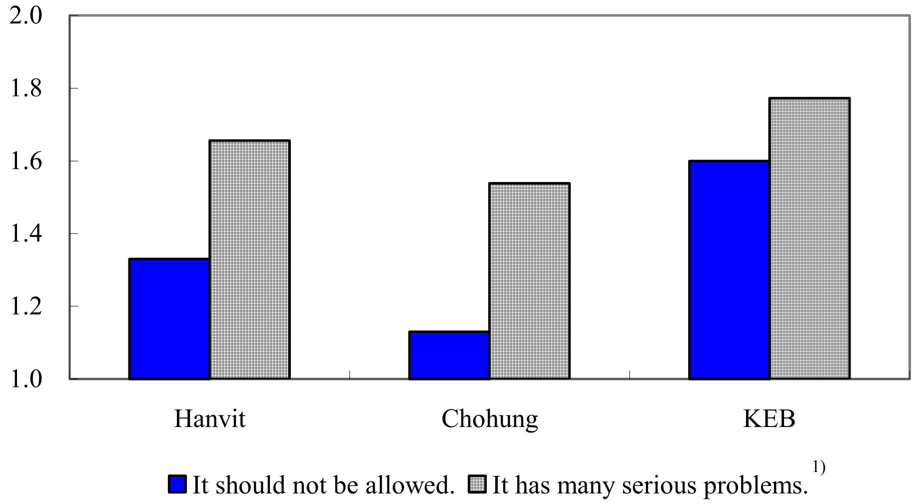
Table 8. Perceptions on Government Ownership or Intervention in Banking and its Impact on Bank Efficiency

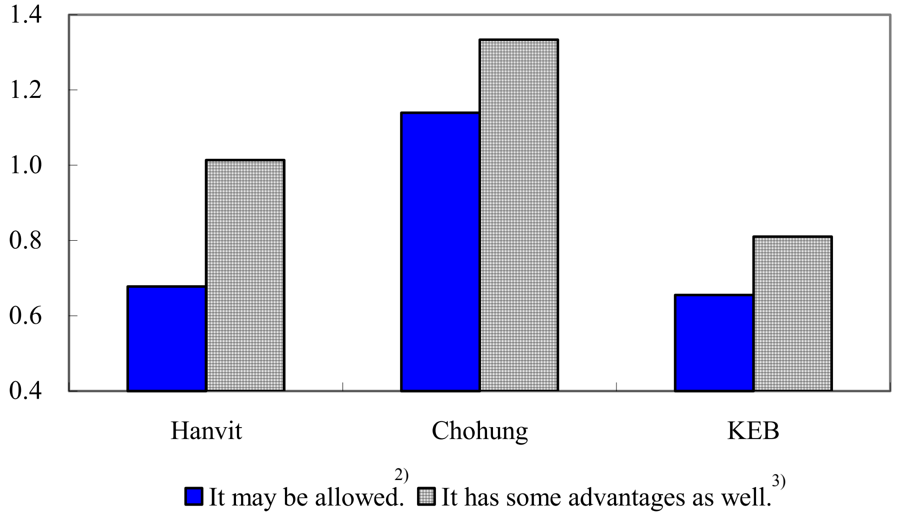
Regression results: response score (-2, 0, 1, 2, 3) as the dependent variable

	Length of Service	Dummy (Chohung)	Dummy (KEB)
Monitoring			
Better monitoring due to higher risk of corporate default including no more "too big to fail"	-0.011	-0.228*	0.037
Bank bargaining power stronger because no firm is "too big to fail"	0.009	-0.422*	-0.001
Bank bargaining power stronger due to reduced interference by bureaucrats or politicians	0.148*	-0.246	0.168
Bank bargaining power stronger since forbearance of bank managers is no longer allowed	0.146**	0.274	-0.217
Monitoring constrained by weak interest of CEO, who is not evaluated solely by performance	-0.052	0.571*	0.782**
Low monitoring incentives due to loan decisions being dictated by supervisors (under outside pressure)	-0.274**	-0.019	-0.084
Low monitoring incentives since some clients are "too big to fail"	-0.154*	0.265	0.169
Relationship banking			
Progress toward relationship banking due to less bureaucratic/political interference	0.123	0.050	0.199
Bank governance			
Weak discipline in bank management due to government ownership or interference	-0.252**	0.300	0.130
Weak discipline in bank management due to banks' moral hazard (deposit insurance, bailout, etc)	-0.062	-0.162	-0.026
Government-owned banks inefficient as senior managers' management autonomy is restricted	-0.076	0.130	-0.041
Government-owned banks inefficient due to outside interference in banking operations	-0.098	-0.030	-0.231
Government-owned banks inefficient due to complacency (expectation of bailout)	-0.215**	0.737**	0.715**

Notes: ** and * indicate statistically significant at the 1% and 5% level, respectively.
Length of service: 1 for 5 years or under; 2 for 5-10 years; 3 for 10-15 years; 4 for 15-20 years; 5 for 20-25 years; and 6 for 25 years or over.

Figure 2. Perceptions on *Chaebol* Ownership and Control of Banks





Notes: [1)] Average score on question #4 in Box 4.
[2)] Average score on question #3 except the first item in Box 4.
[3)] Average score on question #5 in Box 4.

Summary evaluation of the survey results

The responses to some of the questions seem to indicate that relationship banking is far from firmly established in Korea, which is hardly surprising. First, even though monitoring has been intensified since the financial crisis in late 1997, the major effort has been directed toward *ex ante* monitoring (screening of loan applications) rather than relationship-intensive *interim* or *ex post* monitoring. Second, bank officers' understanding of the advantages of relationship banking for corporate clients is rather limited, though they understand them well from the bank's point of view. Relationship banking is even less appreciated by more experienced officers. Finally, responses to a hypothetical situation of a client firm in financial distress are partly inconsistent with what can be expected from a relationship bank.

The most important factors motivating better monitoring and relationship banking turn out to be higher risk of corporate default and the banks' own survival, as well as the better information base they have built since the onset of the financial crisis. More structural factors, including changing bargaining power vis-à-vis client firms and banks' holding of equity shares in their corporate clients, do not appear to have played a major role. This may indicate that banks' enhanced efforts for monitoring and relationship banking may be weakened if the financial situation in the corporate and banking sectors improves. However, current efforts in this area seem to be institutionally supported as part of prudential regulation and the organizational innovations of banks emphasizing relationship management, which might provide a more permanent base.

Finally, officers of the sample banks that are owned solely or largely by the government are well aware of the problems of this ownership and governance structure: political or bureaucratic intervention may distort the process of CEO appointment or dismissal and weaken managerial initiatives as well as discipline in bank management.[29]

They also express concern about *chaebol* control of banks and the associated side-effects. It will be a great challenge to privatize these banks as soon as possible, while still putting into place a desirable structure of ownership and governance. Though these officers prefer to see their banks owned and controlled by a group specializing in finance, the financial groups currently existing in Korea do not seem to be strong enough to control these banks. It is interesting that these respondents prefer the option of joint ownership/control by *chaebols* and foreign financial institutions to widely-held ownership with control exercised by institutional investors. The option, which brings both capital and expertise, with each holding the other in check, may allow relatively early privatization without a great depressing effect on the stock market.

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[29] The Korean financial supervisory authorities have required city banks to introduce a "bank president recommendation committee" to select their CEOs since 1993. The committee is composed of 3 previous presidents of the bank, 2 representatives each for large and small shareholders, and 1 representative each for corporate and individual customers. From 2000, the "candidates recommendation committee" composed of all outside directors selects the president and auditor of the bank. Outside directors are required to constitute a majority of bank board of directors; and 70% of outside directors are to be appointed by the shareholders, while the remaining 30% are selected by the board of directors. In reality, the financial supervisory authorities are believed to have substantial influence on the selection of presidents for government-owned banks.

6. Conclusion

The empirical evidence on various aspects of relationship banking is rather mixed in most cases, a fact which may be attributable partly to the difficulty of defining relationship banking in practice. Nevertheless, it seems that nearly none of the theoretical arguments on the merits and demerits of relationship of relationship banking can be easily refuted on the basis of empirical evidence, though they are not overwhelmingly supported either.

Relationship banking can reduce information asymmetry between a business firm and its creditors, making the relationship bank (and other creditors) willing to give easier access to credit, allowing the firm to mitigate liquidity constraints in its investment activities. Based on this information, relationship banks are often willing to provide insurance functions to their client firms. This can take the form of adjusting the terms of loans according to the cyclical business situation, or giving more intensive care to the client firms in times of financial distress. Here, relationship banks can play a critical role in corporate governance. At the first sign of serious deterioration in the performance in a client firm, the relationship bank begins to intervene in corporate management, typically sending a banker to the board of the firm to help better handle the problems of financial distress. Depending on the severity of the situation, the banker may devise a corporate restructuring plan and direct its implementation. This contingent corporate governance may indeed provide a flexible, informal alternative to the roles played by the market for corporate control or bankruptcy proceedings.

The empirical evidence also seems to demonstrate the risks of relationship banking. Creditor banks tend to discourage risk-taking by client firms, and this may constrain the full realization of corporate growth potential. Also, a firm may be informationally captured by its relationship bank, making it difficult to turn to other financial sources and forcing the firm to pay monopoly rents to the bank. When a relationship bank is also a shareholder of a financially distressed firm, it may influence corporate decisions in its interest, making other creditors less willing to provide additional credit due to potential conflicts of interest. As the result, the net effect on corporate efficiency is ambiguous, not only theoretically but empirically as well.

Furthermore, the roles of relationship banks seem to be best played under certain financial market conditions faced by corporate clients. For instance, when the capital market is deregulated, giving firms easier access to cheap capital, relationship banks may lose their grip on the firms and little monitoring will be undertaken. Also, in the presence of asset price bubbles, relationship banks may neglect their monitoring or insurance functions, and may not be able to fulfill their implicit obligations in the face of massive corporate defaults or a financial crisis. As the corporate financing environment changes, the client base of banks also changes. At such times, banks tend to be strained in their monitoring activity, since they have to keep monitoring inactive clients (for existing loans or guarantees) in addition to intensifying relation-specific investments with new clients.[30]

[30] Yoshida (2001) provides a case study of Asahi Beer and its MB, Sumitomo Bank. In spite of its decreased reliance on bank loans, Asahi maintained a strong relationship with Sumitomo in the late 1980s: Sumitomo was its third largest shareholder, dispatched most top managers, underwrote corporate bonds, and guaranteed bonds issued by Asahi. Though Sumitomo was in a position to properly monitor

Bank-based corporate governance is certainly an option for Asian economies. The capital market-based Anglo-American model requires many institutions to support the system: legal, accounting, auditing, credit rating, investment consulting, investment banking, disclosure and other fair trade rules, internal corporate governance mechanisms, and a market for corporate control, to name just a few. It would take much time and effort to build these institutions, and there is no assurance that this model would work, as is well attested by the series of accounting misdeeds resulting in meltdown of Enron, WorldCom and other large corporations. While the above institutions are also necessary for any form of corporate governance, the market-based model requires a much stronger institutional base. Thus, Asian countries may be advised to make the best use of banks for corporate governance, along with efforts to strengthen relevant capital market institutions. High corporate dependence on bank borrowings in most Asian economies also puts banks in an ideal position to play a role in corporate governance.

A critical constraint in this role for Asian banks is poor corporate governance of the banks themselves. When banks are controlled by the government, frequent interference by bureaucrats or politicians limits the scope for relationship banking. In the case of banks that are owned and controlled by family-based business groups, relationship banking is likely to be geared toward maximizing family interests. Corporate governance in widely-held banks also tends to be very poor due to the characteristics of the banking industry: takeover threats are usually absent; the market is typically oligopolistic with limited competition; and banks suffer from moral hazard due to the expectation of government rescue. Many banks are newly in the hands of the government in the crisis-hit Asian countries. One challenge involves how to strengthen corporate governance in these government banks and what ownership and governance structures should be introduced when they are privatized in the future.

Deregulation and increased competition in the financial markets is often considered a threat to relationship banking. However, once relationship banking has become firmly established between a bank and its corporate clients, the relationship is likely to be maintained, since the bank's informational advantages can be kept with modest additional effort. In situations where competition is mainly in the capital market, relationship banking might be even more valued, particularly for small and medium-sized firms and young firms without adequate access to venture capital. More importantly, with the transition to a universal banking system, relationship banks can continue to make use of the informational advantages about their clients in the securities business, even though they may no longer rely on bank loans. A universal banking system requires strengthened prudential regulation to deal with the increasing scope for banks' abuse of conflicts of interest. The challenge is substantially larger if the banks are controlled by family-based conglomerates.

Relationship banking comes under stress when the client firms or banks are in financial distress. In order to better help a client firm in financial difficulty, the relationship bank may need to intervene in corporate management by dispatching a banker to the corporate board of directors. The banker faces a conflict of interest, having a fiduciary duty to both the owners of the firm as well as the bank. This conflict and the

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Asahi, there was actually a vacuum in MB monitoring, leading to the deterioration of Asahi Beer's financial status.

possibility of consequent liability for losses by other stakeholders may constrain the bank's much-needed corporate governance role. To deal with this problem, an efficient mechanism for coordination among creditors is needed. Relationship banking may be a curse when the bank cannot fulfill its implicit obligations due to its own financial problems. Firms are likely to have difficulty turning to other banks or investors because of the informational monopoly by the bank. Moreover, if the bank goes bankrupt, its information capital accumulated through relation-specific investment is mostly lost. Since this represents a loss to the economy beyond the bank's book value, care needs to be given to the restructuring of banks so that this information capital can be saved to the extent possible.

The questionnaire survey conducted among the officers of large Korean banks shows that monitoring and relationship banking have been substantially furthered by reduced moral hazard on the part of banks and large businesses as well as the accumulation of better information following the crisis. At the same time, it indicates that relationship banking is not yet firmly established in these banks, which is not surprising given that it has been just few years since they were placed under the new business environment in the wake of the crisis. The respondents in the sample banks in which the government has an exclusive or *de facto* majority share, following the injection of public funds, believe that their banks are critically constrained by the government ownership and political or bureaucratic interference in banking operations. They are also well aware of the potential problems of ownership and control by *chaebols* as well as those of diffusely-held banks. It will be a great challenge to divest the government ownership of these banks as soon as possible while ensuring sound governance in the privatized banks.

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