The Personal Side of Relationship Banking

Principal Investigator: Prof. Antoinette Schoar, MIT
Presenter: Sharon Buteau, Executive Director SEFC

Impact and Policy Conference:
Evidence in Governance, Financial Inclusion, and Entrepreneurship

August 30th, 2012
Motivation

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

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

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

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

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

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

- Focus on first dimension: Better screening of borrowers

- Organizational structure of banks and relationship banking

- Role of prior relationship in repayment behavior
  - Puri et al. (2012) and Drexler and Schoar (2012)
Set up: Small Business Loan Facility of ICICI Bank

Challenge: Moral hazard versus information asymmetry

ICICI Bank SME Online

I got big success with just one smart move.
Get SME Loan up to Rs. 10 crore
Set up

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

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

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

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

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

**Group D: No monitoring treatment**
Control Group
Implementation of the Experiment I

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

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


Implementation of the Experiment II

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

• Total experiment period was July 2007 to April 2009

• Sample: 1319 SBA loans across all regions of India were assigned to treatment and control groups
Data and Outcome Measurement

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

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

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

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

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

Coefficient of Treatment Dummy from OLS Regressions on Delinquency Measures
Other Results

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

Coefficient of Treatment Dummy from OLS Regressions on Delinquency Measures
Summary

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

• Model is sustainable: Improvement in late payments outweighs the cost of tele-callers
My question is: Are we making an impact?