Relationship-Based and Arms-Length Financial Systems

A European Perspective

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Abstract

This paper surveys the debate on arms-length and relationship-based financial systems with a special focus on the Eastern Europe and Central Asia region. The paper argues that while the initial dominance of relationship-based systems in the region is consistent

with the implications of the theoretical literature, the subsequent improvements in supporting institutions coupled with structural changes suggests a greater scope for arms-length elements going forward.

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Relationship-Based and Arms-Length Financial Systems—A European Perspective

by

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Relationship-Based and Arms-Length Financial Systems¹

1. Introduction

Within the group of financially developed economies, both the overall importance of the financial sector in GDP and the composition of financial systems differ significantly. An active literature explores the importance of these differences in financial structure for longer-term economic performance. One popular distinction, also used in this paper, distinguishes between *arms-length financial systems* (ALFS) and *relationship-based financial systems* (RBFS), with the United Kingdom and Germany commonly used as illustrations of the two types.

Ideal-type ALFS treat individual financial transactions as separate decisions, individually structured and priced and provided by the financial institution offering the best transaction-specific service. Long duration and broad ranging relationships between financial firms and customers are rare. Ideal-type RBFS in contrast emphasize long-term relations between customers and a specific financial institution. Individual transactions take place and are priced in the context of this long-term relationship.

Though theoretically distinct, the concepts of ALFS and RBFS are in the discussion often co-mingled with the relative weight and functions of banks and capital markets, and with other financial market and broader economic characteristics. In this broader view – empirically fairly accurate for the post-war period until the 1990s, but less so for the nineteenth century and the most recent period – relationship based financial systems are characterized by an above average importance of universal banks, relatively small bond and equity markets, and limited emphasis on formal disclosure and corporate governance standards. In contrast, arms-length financial systems in this broader view are held to be characterized by smaller specialized banks, a greater importance of capital markets, extensive formal disclosure and corporate governance standards and a typically greater reliance on formal legal dispute resolution mechanisms.

The literature on the comparative (de)merits of ALFS and RBFS underwent significant swings over time, a feature noteworthy in itself. In continental Europe, relationship based financial systems were widely seen as an efficient arrangement to collect savings, select investment projects and monitor borrowers in the specific context of the late nineteenth century and the early post-1945 decades, two periods of strong growth in countries with RBFS. In the wake of the subsequent reversal in relative performance ALFS gained credence as being better suited to fostering innovation, competition and structural adjustment. In contrast, RBFS were increasingly seen as part of the broader set of formal institutions and informal arrangements contributing to slower

¹ This is a background paper to a forthcoming World Bank report titled “Golden Growth: Restoring the Lustre of the European Economic Model.” I am very grateful to Juan Zalduendo and Anne-Marie Gulde for comments on an earlier draft. The views expressed in this paper are those of the author. They do not necessarily represent the views of the International Bank for Reconstruction and Development and its affiliated organizations, or those of the Executive Directors of the World Bank or the governments they represent. The author may be contacted at wolfhc@georgetown.edu.

growth. The current crisis will further shape the debate, though it is too early to draw firm conclusions.

This background paper takes a closer look at the debate contrasting arms-length and relationship-based financial systems. The next section briefly reviews the general literature, framed in terms of ideal-type systems. Against this background, the third section considers financial system structure in the Eastern Europe and Central Asia (ECA) region through this specific lens.

2. Financial System Structure

Controlling for the level of financial development, does the structure of the financial system matter systematically for performance? Addressing this question requires a classification of financial systems into well-defined categories.² A popular classification scheme focuses on the dominant source of external funding, distinguishing between *bank-based* and (capital) *markets-based* systems. A second popular scheme is based on the type of relationship between customers and financial institutions, distinguishing between *relationship-based financial systems* (RBFS) and *arms-length financial systems* (ALFS). A third classification within the broader varieties of capitalism literature distinguishes between Liberal Market Economies (LME) and Coordinated Market Economies (CME).³

The early post-war decades witnessed substantial overlap across classifications, with bank-based, relationship-based systems in CMEs and market-based, arms-length systems in LMEs providing clusters. The overlap is however less pronounced for the late 19th century⁴ and arguably for the more recent period. In recent decades the combination of banking system consolidation and efforts to cross-sell services has raised the importance of relationship-building repeat transactions in ALFS while equity and corporate debt markets have experienced significant growth in RBFS. Notwithstanding these caveats, the overlap between the banking/markets and the RBFS/ALFS dichotomies arguably remains sufficiently pronounced for the modern period to serve as a usable joint classification scheme, and will be employed in this limited sense for the remainder of the paper.

Relationship-Based and Arms-Length Financial Systems – A Capsule Review

Well functioning financial systems efficiently collect and allocate savings and monitor their use. Both RBFS and ALFS perform these tasks, but do so in different ways, solving some information and incentive challenges but not others and potentially creating new challenges. These features of alternative financial system structures and their effects have been explored in a sizable literature. The following review cannot do full justice to

² See e.g. Levine (1997, 2002), Beck, Demirgüç-Kunt and Levine (2000), Beck, Demirgüç-Kunt and Maksimovic (2002), Fohlin (2000) and Beck and Demirgüç-Kunt (2009).

³ See e.g. Peter Hall and David Soskice (eds.) (2001).

⁴ See e.g. Fohlin (2000), Rajan and Zingales (2002).

the richness of this literature⁵ but rather aims to provide a capsule summary of core issues of relevance to the ECA region, structured in terms of potential advantages and disadvantages of the two ideal-type systems. It is worth emphasizing that many of these features are themselves the subject of extensive theoretical and empirical debates. Furthermore, their relevance may be strongly context dependent, and specifically influenced by the broader institutional framework in place, an issue taken up below.

Potential Benefits of Relationship-Based Financial Systems

Information and Monitoring: The long-term relationship – at times enhanced by equity stakes and board positions – coupled with the broader information generated through the scale of large universal banks provides banks both the opportunity and the incentive to develop in-depth knowledge of their customers, reducing challenges associated with information asymmetry and facilitating monitoring.

Smoothing/Long-Term Focus: The value of maintaining the long-term relationship provides an incentive to continue the funding of borrowers during lean periods, facilitating longer-term planning and reducing the need for self-insurance.

Contract Enforcement: The option value for both financial firms and customers of maintaining the long-term relationship provides a strong incentive to resolve contract disputes internally.

Potential Drawbacks of Relationship-Based Financial Systems

Status Quo Bias: The desire to maintain the value of the investment in existing relationships creates a preference for funding incremental projects in established firms. Borrowers with primarily intangible assets, start-ups with disruptive technologies or strategies challenging incumbents might consequently struggle to obtain financial backing (Rajan and Zingales (2002)).

Financial System Competition and Information: The information advantage of the incumbent lenders, coupled with the incentive for borrowers to maintain the long-term relation as insurance against idiosyncratic shocks and the absence of incentives to disclose information to third parties reduces the ability of other financial institutions to compete for established customers and may impede the development of capital markets.

Potential Benefits of Arms-Length Financial Systems

Funding Change and Facilitating Adjustment: The existence of a broad range of alternative funding sources, coupled with a lower inherent preference for continuing existing financial relationships raises the likelihood of funding for new technologies and firms and facilitates adjustment to permanent shocks through borrowing.

⁵ See the literature references for extended discussions, including the contributions in Demirgüç-Kunt and Levine (2001) and the discussion in Rajan and Zingales (2002). Levine (1997, 2002) provides comprehensive assessments.

Financial System Competition: The reduced importance of lock-in effects for both financial firms and customers generates competitive pressures favoring financial system innovation and efficiency.

Information and Liquidity: Stringent disclosure requirements provide widely available high quality information supporting liquid capital markets.

Incentives/Monitoring: Capital markets provide effective avenues to align incentives, potentially reducing the need for and cost of direct monitoring.

Potential Disadvantages of Arms-Length Financial Systems

Information and Monitoring: The lower prevalence of repeat business reduces incentives for investors to invest in information acquisition.

Funding Droughts: Uncertainty about the availability of reliable long-term funding enhances the need for self-insurance and may impede pursuit of long-term investment projects.

Dispute Resolution: The transient nature of financial transactions reduces the incentive to resolve disputes internally.

Supporting Institutions

The cost-benefit calculus of financial system structures is influenced by the ability of supporting institutions – ranging from self-organized industry institutions to national and international institutions - to enhance returns and to mitigate risks. Among the broad set of relevant institutions discussed in the literature, three merit particular attention:

Disclosure Standards: The ability of arms-length systems to efficiently allocate capital depends on the quality of the available information. High quality information disclosure and accounting standards (complemented by effective protection of minority shareholder interests) is thus fundamental to the efficient operation of ALFS while mitigating some of the disadvantages of RBFS.

Legal System Nature and Effectiveness: A broad literature finds that access to external finance and the structure of financial systems is related to both the fundamental legal system – with common law systems held to be more favorable for the development of ALFS - and the efficiency of legal conflict resolution.⁶

Risk-Reduction Measures: Real world RBFS and ALFS have displayed a historical predilection towards specific types of resource misallocation occasionally triggering financial crises. While not intrinsic to the ideal type financial systems, these

⁶ See La Porta, Lopez-de-Silanes, Shleifer, and Vishny (1997,2002), Demirgüç-Kunt and Maksimovic (1998), Demirgüç-Kunt and Levine (2001a), Beck, Demirgüç-Kunt and Levine (2003) *inter alia*.

misallocation episodes are sufficiently frequent to merit including effective risk-reduction mechanisms for both the banking system and the non-bank financial sector including macro-prudential measures among the relevant supporting institutions.

Empirics and Issues

The relative merits of bank-based/RBFS and market-based/ALFS have been the subject of extensive empirical work.

Historical case studies, notably assessments of industrialization in late 19th century Western Europe have importantly shaped the evolving debate. A popular view – dating back to Alexander Gerschenkron’s (1962) analysis – argues that Britain, with already well developed capital markets and a fairly extensive and differentiated banking system – including country, national and internationally focused banks - was able to rely on a diverse set of financial structures to fund industrialization, reaping the maximum benefits from the two-sided feedback loop between financial and real development. Conditions on the continent in this view were less propitious. Conditional on the starting point, the emerging financial structure centered on banks with deep ties to their customers was however seen as an effective arrangement for funding the catch-up process, with the German three pillar system centered on the large universal banks complemented by savings and co-operative banks focused on the small business sector gaining particular attention. More recent empirical work including comparative studies however qualifies some of the central tenets of this dichotomous view in terms of both features and measurable outcomes.⁷

The case studies permitting in depth exploration of national idiosyncrasies are complemented⁸ by a recent literature exploring the linkages for broad cross-country datasets⁹ documenting a strong link between financial development and economic growth, but tending to find less robust evidence for conditional systemic links between financial system structure and performance. Context dependence, with both RBFS and ALFS better suited for some but not other sets of (partly time-varying) circumstances provides a possible interpretation (Rajan and Zingales (2002)). Under this view, the ability of the financial system structure to adjust to changing circumstances, and the extent to which policy measures can facilitate the adjustment is of obvious interest. The range of relevant determinants discussed in the literature ranges broadly from deep parameters largely outside the scope of policymaking to slowly changing features and specific factors – such as detailed provisions of bankruptcy rules or tax laws - amenable to intervention.¹⁰ In considering these theories, the profound long run stability of overarching financial system structures (Fohlin (2000)) provides some support to views focusing on deep structural parameters, though persistence may also result from the combination of time varying factors and feedback loops.

⁷ See in particular Fohlin (1997,2000)) as well as the contributions in Forsyth and Verdier (eds. 2003).

⁸ See Levine (1997,2002) for integrated assessments of the literature.

⁹ See e.g. the studies in Demirgüç-Kunt and Levine (eds. 2001).

¹⁰ Largely invariant or slow changing factors include the structure of the legal system (La Porta et al. (1997, 2002)) and the interaction between political structures, financial system governance and financial system structure (Verdier (2002)).

3. Financial System Structure in ECA

The preceding sections reviewed the theory of RBFS/ALFS. This section turns to the implications of the debate for countries in the ECA region previously operating under central planning. The discussion focuses on widely shared characteristics in the context of the broader RBFS/ALFS debate and does not cover individual country experiences. While abstracting from intra-region heterogeneity is defensible for some of the more general issues raised, some specific issues, in particular actual or potential membership in the European Union for some countries in the region, raises specific issues taken up separately.

Properties of ECA Financial Systems

With some cross-country variability (Mitra, Selowsky and Zalduendo (2010)), the financial markets in the ECA region that have managed to cross the “great divide” (Berglof and Bolton (2002)) tend to be characterized in international comparison by (a) a relative low overall financial system depth, (b) a large role of banks relative to capital markets, (c) a modest role of private relative to public bond markets, (d) small equity markets, (e) a high reliance of the banking system on external funding, (f) a small share of local currency long duration private sector instruments and (g) unusually high credit growth prior to the financial crisis.¹¹ One of the most notable features setting apart the region is the importance of domestic subsidiaries of foreign banks (Schoenmaker (2011))¹² accompanied by a high share of foreign currency deposits and loans.

Initial Financial System Structure

The transition from plan to market constituted a pronounced institutional disruption. For the CEE operating under continental RBFS in the interwar period, decades of monobanking under central planning, coupled with the changes during the transition effectively eroded any pre-existing information advantage. While the mitigation of information-based lock-in effects broadened the scope for financial system choice, in practice the heterogeneity of the emerging financial system structures was limited, clustering around bank-dominated systems, albeit it with some important intra-region differences (Mitra, Selowsky and Zalduendo (2010)).

The revealed choice in the initial transition period is overall consistent with the implications of the theoretical literature. Based on country-specific factors, significant productivity gaps, shallow (private) financial markets, legal systems falling predominantly into the German or French tradition¹³ and gaps in de jure and de facto disclosure standards, corporate government structures and legal dispute resolution mechanisms according to the theoretical framework tilts the cost-benefit calculus towards

¹¹ See e.g. Berglof and Bolton (2002), EBRD Transition Report (2009, 2010), Mitra, Selowsky and Zalduendo (2010), Adarov and Tchaidze (2011), Csajbok and Gnan (eds. 2011) and Schepers (2011) *inter alia*.

¹² In some cases reflecting deliberate policy choices (Mitra, Selowsky and Zalduendo (2010))

¹³ See Pistor, Raiser and Gelfer (2000).

bank-based/RBFS. Arguments based on firm specific characteristics (see e.g. Rajan and Zingales (2001)) likewise point to bank-based systems as the type of firms most likely to prefer and be able to access capital markets as source of external finance – large well established firms seeking diversified sources of external finance, start-ups in new sectors and firms with large intangible assets – constituted a small share of the overall universe of firms in the early transition period.

Current Financial System Structure

The historical experience with financial systems suggests that structures, once established, display strong persistence. Future changes in the region are thus most likely to complement the current bank-based structures. With this caveat, the significant changes over the last two decades have raised the scope for arms-length financial market elements. In particular, sustained growth differentials relative to the EU-15 (though disrupted by the financial crisis) have narrowed the productivity gap and increased the share of firms with characteristics thought to be more amenable to external financing through capital markets. Supporting institutions have strengthened, though significant gaps in institutional infrastructure relative to advanced market economies remain for a number of countries in the region, with de facto standards often lagging behind de jure standards.¹⁴ Yet despite the strengthening of factors viewed as supporting the development of capital markets¹⁵, stock and private bond markets remain fairly small and illiquid alongside a scarcity of domestic currency long-term instruments, raising the question whether the causes are to be sought primarily on the demand or the supply side.¹⁶

International Integration

The theoretical literature reviewed above primarily focuses on the structure of the domestic financial systems. For the ECA region, the particularly pronounced degree of international financial integration also requires a close look at the role played by foreign financial institutions (notably banks) in the domestic financial system and the options available to domestic financial institutions, firms and households to access foreign financial markets.¹⁷

As noted above, subsidiaries of foreign banks account for an unusually large share of the banking system in a number of ECA region countries (Schoenmaker (2011)). In

¹⁴ See the annual ratings and discussions in the EBRD Transition Report. Gaps are on average larger for countries that are not current or potential EU member states and may thus constitute one reason for the underdevelopment of capital markets in this group, but are less pronounced and thus arguably play a lesser role for current and potential EU member states (Adarov and Tchaidze (2011)).

¹⁵ In addition, the cross-country evidence suggests that banking system and financial market growth are positively associated. See Demirgüç-Kunt and Maksimovic (1996), Demirgüç-Kunt and Levine (2001b) and Schepers (2011).

¹⁶ See EBRD (2010) for the region and Adarov and Tchaidze (2011) on the role of institutional features and other factors in explaining relative financial development in the CE4.

¹⁷ The latter caveat is particularly important for equity markets, where economies of scale have led to a gradual move from regional to national to cross-national exchanges.

terms of the RBFS/ALFS debate, it is noteworthy that the home countries of the subsidiaries frequently have historical ties to the host country, which may translate into familiarity¹⁸ with both legal structures and business practices and thus provide a fertile ground for the subsidiaries developing firm specific relationships.

Building lasting relations requires a durable commitment of the foreign banks to the countries in question. Concerns that in case of financial crisis subsidiaries would curtail funding to a greater extent than domestic banks – impeding their ability to sustain relationships over the long term and thus their role in a RBFS – have not been born out in the recent financial crisis. Partly reflecting the Vienna Initiative, subsidiaries largely sustained their presence in the region. Indeed, comparative performance suggests that a reliance on foreign banks may have exerted a stabilizing influence relative to reliance on other types of external funding.¹⁹ Overall, the role of foreign banks in the ECA region as participants in RBFS is thus somewhat unusual, as the literature tends to view the entry of foreign banks primarily as a challenge to existing RBFS.

For the subset of ECA countries that are current or potential future member states of the European Union, international integration also has an institutional component through the (current or future) adherence to European Union financial sector policies – guided by the goal of achieving an integrated market for financial services. In terms of the RBFS/ALFS debate, the adoption of a high quality shared supporting infrastructure with common and enforceable standards enhances the feasibility and benefits of market-centered/ALFS elements.

4. Conclusions

This background paper took a look at the debate on ALFS and RBFS with a special focus on the ECA region. The paper argues that the initial choice of bank-based/RBFS is consistent with the implications of the theoretical literature. Two decades later, substantial improvements in supporting institutions coupled with structural changes - particular for countries that are currently or may become EU members - suggests greater scope for market-based/ALFS elements. The ECA region further stands out for the large role played by subsidiaries of foreign banks, and, for a subset of countries, by the implications of current or potential EU membership. In the traditional RBFS/ALFS literature, international financial integration enters as a challenge to established RBFS. In contrast, foreign banks in a number of ECA region countries appear to have become a constituent part of relationship-based financial systems.

¹⁸ On such proximity effects, see for instance Pistor, Raiser and Gelfer (2000) on the effectiveness of legal systems; Becker, Boeckh, Hainz and Woessmann (2011) on attitudes towards the state and Bottazzi, Da Rin and Hellmann (2011) on trust.

¹⁹ See Mitra, Selowsky and Zalduendo (2010), Revoltella and Mucci (2011), Schepers (2011) and for the general role of financial integration Lane and Milesi-Ferretti (2010).

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