Russell Investments

PORTFOLIO MANAGER INSIGHTS

Are you getting enough from your 'Relationship'?

Understanding the information asymmetry of relationship loans

Clive Smith, Senior Portfolio Manager, Fixed Income

"If you're competing for the highest quality credit, by definition it's going to be on the lower end of the pricing spectrum. ... If that's what's important to you, then how do you supplement lower yields in your loan book? And you do that with the diversity that fee businesses bring to your revenue streams."

-- Mike Hagedom, president and CEO of UMB Bank

As with all relationships between parties there is a knowledge associated with repeated interactions over an extended period of time, which creates an intimacy and various levels of trust, or distrust, between the parties. The evolution of such relationships exists not only in personal relationships but also within financial relationships. Nowhere is this connection more apparent in the realm of finance than in the case of relationship loans. Relationship loans have evolved to satisfy specific informational requirements by leveraging off the longer-term relationships between bank and borrower. Normally this would be of little consequence to investors except that a series of regulatory changes, coming into effect progressively from 2015, have increased the incentive for banks to more proactively manage their balance sheets and as part of the process on-sell portions or complete loans to non-bank investors. Yet it is the very nature of relationship loans which has the potential to create issues once banks set out to sell portions of such loans to external non-bank investors (outsiders). As with any investment potential buyers of such loans need to be aware of the uncertainties associated with determining if one is being adequately compensated for joining in a financial relationship via the purchasing of portions of relationship loans. Yet with relationship loans determining whether one is being adequately compensated is further complicated given that one is now the "outsider" in what is a relationship between the bank and the borrower.

Information asymmetry is the major risk for any lender

There are many risks faced when lending money but the main one which is under the lender's ability to control, up to a point, is the level information asymmetry. Information asymmetry has two aspects namely:

(a) where a borrower has more information regarding the state of its business than the lender and

(b) where one lender is privy to more information regarding a borrower than the other lenders.

The drivers of the level of information asymmetry between borrowers and lenders is ultimately determined by the trade-off between:

(a) costs, both direct and indirect, associated with the borrower making increased amounts of potentially proprietary information available to lenders and

(b) the reduction in borrowing costs associated with the provision of additional information.

Accordingly, the borrower needs to decide on the acceptable cost, both direct and indirect, associated with providing additional information to lenders; and the reduction in borrowing costs associated with providing the additional information, i.e. the borrower seeks to minimise the 'all in' costs of obtaining a loan.

It is logical that a borrower would therefore provide sufficient information so that the costs of providing the additional information to lenders equals the reduction in borrowing costs associated with the provision of the additional information to lenders. The natural tension between borrower and lender occurs as it is always in the borrower's interest to provide no more information to the bank than the bank 'needs' or to selectively provide information to minimise borrowing costs.

Relationship loans allow banks to reduce information asymmetry

This is where relationship lending comes to the fore as it is a means of managing the level of information asymmetry in a more cost-effective manner. In the most general sense relationship lending is simply where there is the provision of funds to a borrower entirely through a financial intermediary. Yet at its heart relationship lending goes much further than simply having the financial intermediary provide funds and implicitly requires that the financial intermediary also have developed proprietary in-house information regarding the client from past dealings and behaviour. More formally relationship lending is defined as *"the provision of financial services by a financial intermediary that:*

i) invests in obtaining customer-specific information, often proprietary in nature; and
ii) evaluates the profitability of these investments through multiple interactions with the same customer over time and/or across products.

A key aspect of relationship banking is that it involves borrower-specific-often proprietary-information available only to the intermediary and the customer" (Boot 1999)[1].

From the borrower's perspective, the benefit from such relationship loans is that it:

(a) reduces the cost associated with having to provide a high level of information to multiple parties and/or
(b) limits the level of dissemination of private information which the borrowers may not view as being suitable or relevant for more public distribution.

Relationship lending serves the very clear purpose of using proprietary information and repeated interactions over time to reduce the level of information asymmetry between the borrower and the bank in a more cost-effective manner.

Banks may value loans differently

Not only may the existence of proprietary information associated with the ongoing relationship with the borrower impact the bank's pricing of the loan directly but there may be other factors which determine how much a bank will charge a borrower.

The first complicating factor is the potential for cross subsidisation through what is referred to more broadly as relationship banking. Relationship banking is where a bank provides a diverse range of services to a client of which simply one is the provision of relationship lending. Under such banking relationships the bank lenders may also be providing additional services to the borrower for which the client is charged. The rates and fees charged on a bank loan may therefore reflect other revenue streams sourced from the borrower. This is not to suggest that relationship lending may be treated as loss leaders but that there may be a level of cross subsidisation between banking services which may impact upon the return associated with a relationship loan when viewed in isolation.

The second complicating factor is that banks consider the making of non-tradeable loans as "part and parcel" of their business and accordingly do not generally charge what non-bank investors would view as a liquidity premium; i.e. an additional return premium to compensate for the lack of a secondary market in a loan.

These complicating factors mean that it is problematic taking the origination return on a relationship loan as an unbiased assessment of the appropriate return for the underlying risks assumed.

[1] Relationship Banking: What do we know?: Arnoud Boot (October 1999)

Buying into relationship loans makes you the 'Outsider'

So why is all this relevant when buying all or a portion of a relationship loan? The key point to stress is that when buying into a relationship loan you are now the "outsider"[2]. **The danger is that any outsider becoming part of that relationship is therefore at a potential disadvantage with respect to knowledge regarding a range of factors about the individuals involved in the original transaction and their motivations.** Put another way the level of transparency which is available into both the borrower and therefore the factors determining the bank's view regarding the appropriate pricing of the loan is potentially much lower. This is critical as an "outsider" does not have as much transparency into:

a) What potentially proprietary information derived by the bank may actually be available or if it exists at all.
b) The extent to which the loan is subsidised.
c) The rationale behind the bank's desire to sell down their exposure to the borrower.
d) The actual borrower as they may not be publicly listed companies which in turn may reduce the information available to "outsiders' from sources other than the originating bank.

Given these uncertainties, and accordingly the potentially higher level of information asymmetry, then all else being equal, the outsider should be requiring a higher return than that required by the originating bank.

As an 'Outsider' the onus is on you to ask the right questions

The earlier points aim to highlight that investing in relationship loans is not as simple as buying a loan from a bank at the yield reflected on the bank's balance sheet. Investors need to be aware that they are the "outsiders" in the relationship and that the banks concept of what constitutes a reasonable return on the loan may differ from their own. Given this anyone investing in such loans should put in place suitable processes to ensure that they are being adequately compensated for being an "outsider" in a relationship which is designed to reduce the level of information asymmetry between the bank and the borrower. For any investor in relationship loans it is not enough to get a higher return, they need to ensure that they are being adequately compensated for the risks being assumed. What constitutes adequate compensation is really up to the individual investor but make sure that as the "outsider" you ask the right questions before investing in relationship loans.

[2] It is here that investors need to be clear about another difference between relationship loans and other types of lending. With respect to relationship loans negotiation is done "one on one" between the bank and the "outsider". This differs from other types of debt sold via auction such as syndicated loans or traded corporate bonds where the majority, if not all, of the participants are in a sense "outsiders" and so in order to limit the level of information asymmetry the facility organiser has an incentive to make sufficient information available to all the lenders so as to reduce the cost to the borrower and maximise participation. These incentives do not necessarily exist to the same degree, if at all, with respect to relationship loans where the loan is originally priced according to the more proprietary information available and the broader banking relationship with the lending bank.

FOR MORE INFORMATION

Visit russellinvestments.com/au or call (02) 9229 5111

First used: MAY 2017

AUST1-2017-06-07-0621