J. Finan. Intermediation 21 (2012) 97–122

Contents lists available at SciVerse ScienceDirect

J. Finan. Intermediation

journal homepage: www.elsevier.com/locate/jfi

Loan officers and relationship lending to SMEs

Hirofumi Uchida [a,*], Gregory F. Udell [b], Nobuyoshi Yamori [c]

[a] Graduate School of Business Administration, Kobe University, Kobe, 657-8510 Hyogo, Japan
[b] Kelley School of Business, Indiana University, Bloomington, IN 47405, United States
[c] Graduate School of Economics, Nagoya University, Nagoya, 464-8601 Aichi, Japan

ARTICLE INFO

Article history:
Received 27 April 2009
Available online 15 June 2011

Keywords:
Relationship lending
Small- and medium-sized enterprises
Soft information
Hierarchical organizations

ABSTRACT

Previous research suggests that loan officers may play a critical role in relationship lending by producing soft information about SMEs. For the first time, we analyze this hypothesis and find empirical evidence that indicates that loan officer activities are associated with bank production of soft information. We also find that loan officers at small banks produce more soft information than at large banks, but large banks appear to have the equivalent potential to underwrite relationship loans. Nevertheless, large banks choose instead to focus their resources on transactions lending.

1. Introduction

The recent literature on SME financing has emphasized the dichotomy between soft information and hard information. Specifically, this literature has identified soft information with "relationship lending" and hard information with "transactions-based lending" (e.g., Berger and Udell, 2002; Stein, 2002; Berger et al., 2005). In contrast to hard information, soft information is not easily quantified and consists of information gathered over time through contact with the firm, the firm's management/entrepreneur, the firm's suppliers and customers, and other local sources.[1] Ultimately the production of soft information can improve contracting efficiency and increase borrower access to credit

* Corresponding author. Address: Graduate School of Business Administration, Kobe University, 2-1 Rokkodai, Nada, Kobe 657-8510, Japan. Fax: +81 78 803 6949.

E-mail addresses: uchida@b.kobe-u.ac.jp (H. Uchida), gudell@indiana.edu (G.F. Udell), yamori@soec.nagoya-u.ac.jp (N. Yamori).

[1] Soft information can include assessments of a borrower's future prospects culled from contact with borrower's suppliers, customers, competitors, or neighboring businesses (Petersen and Rajan, 1994; Berger and Udell, 1995; Mester et al., 1998; Degryse and van Cayseele, 2000).

1042-9573/$ - see front matter © 2011 Elsevier Inc. All rights reserved.
doi:10.1016/j.jfi.2011.06.002

(e.g., Diamond, 1991; Boot and Thakor, 1994; Petersen and Rajan, 1994; Berger and Udell, 1995, and Boot, 2000).[2]

Some recent work on relationship lending has placed more emphasis on the importance of bank loan officers in producing soft information because it is the loan officers themselves that have direct contact with the bank's borrowers. More specifically, in the SME market loan officers are responsible for conducting due diligence during the underwriting phase and monitoring the borrower after the loan is disbursed (e.g., Berger and Udell, 2006). However, institutional frictions may make it difficult for loan officers to communicate soft information within banking organizations without significantly diluting its content (e.g., Stein, 2002; Alessandrini et al., 2009; Liberti and Mian, 2009). This implies that the relevant relationship in SME lending is the *loan officer–entrepreneur* relationship, not the *bank–entrepreneur* relationship (see Berger and Udell, 2002).

Despite the theoretical importance of the loan officer to relationship lending, there has been very little direct empirical research on the role of the loan officer in providing this lending technology. The theoretical underpinnings of relationship lending suggest some clear and interesting empirical implications: If the loan officer plays such an important role in relationship lending, then we would expect to see a link between loan officer attributes and loan officer underwriting/monitoring activities, and the production of soft information. For example, we would expect to see an association between the production of soft information and such things as the skill level of the loan officer (an attribute), and the frequency of contact between the loan officer and the borrower (an activity).

The purpose of our paper is to, for the first time, empirically explore these associations by using a unique data set, the *Management Survey of Corporate Finance Issues in the Kansai Area*. This survey, conducted in Japan in June 2005, affords us a window on the role of loans officers and soft information production that was simply not available in prior studies. The survey contains data on firms and their loan officers based on a questionnaire sent to SMEs in the Kansai area of Japan.

The richness of these data allows us to overcome some key obstacles in analyzing these issues. First, we have the ability to measure the amount of information produced. We do this by exploiting questions in the survey that ask the respondent firm to rate their main bank on different characteristics of the bank's knowledge of the firm. From this information we construct an index of a banks' overall knowledge of its borrowing firms.

Second, using this index, we can examine whether loan officer activities as measured by loan officer turnover and loan officer underwriting (e.g., frequency of meetings and method of contact) affect the production of borrower information. Because most of these activities are not likely to be devoted to producing hard information, a finding that these attributes matter can be interpreted as suggestive evidence that soft information is produced by, and resides with, loan officers. Because these variables have not been available in prior research, we now can ask *how* soft information is produced.

Regressing our measure of bank information production on the loan officer activity variables, we find evidence that the activities of loan officers matter in producing soft information. Our most important finding is that more soft information tends to be accumulated when loan officer turnover is less, and when loan officer contact is frequent. These findings support the idea above that the ''relationship'' in relationship lending is indeed the *loan officer–entrepreneur* relationship, not the *bank–entrepreneur* relationship.

We also examine whether soft information and the role of loan officers differ from small to large banks. Consistent with the prior literature (e.g., Berger et al., 2005; Uchida et al., 2008) we find that small banks are more active in producing soft information. However, we find that the way that loan officers produce soft information may not be substantially different in large banks than in small banks, although large banks tend to do less of it. Thus, if loan officers at large banks were more ''active'', they appear to be capable of producing as much soft information as they do at small banks. This is not consistent with theoretical models that argue that small banks are a more efficient organizational form for delivering relationship lending (Stein, 2002). However, our result here is consistent with a recent paper that finds that relatively autonomous branches of large banks can produce soft information

[2] While the benefits from improved efficiency could accrue to the borrowers, a hold-up problem or a winner's curse on the part of other uninformed banks may shift the benefits to lenders (Sharpe, 1990; von Thadden, 2004; Black, 2008). Note, however, that the fundraising ability of banks may limit their capacity to provide credit.