# THE CREDIT RELATIONSHIP BETWEEN BANKS AND COMPANIES AND ITS EFFECTS ON THE REAL ECONOMY

**Constantin-Bogdan, Voroneanu**[1]

**Abstract:** *Among the relationships between companies and the financial - banking market representatives, those which are determinate by the lending activity hold a special place. Despite of various alternatives to mobilize the necessary funds to cover the capital needs arising from the current or investment activity, bank loans are the main source of funding for most of the companies. This dominance is assured by the benefits that a bank loan offers to companies and which influence directly and positively their economic and financial situation. Of course there are a number of risks assumed by the company when calling to bank financing, risks which can affect negatively their business if it occurs. Given the important role that companies play in generating of the real flows in the economy, all these positive or negative effects directly impact on the quality of economic and social life at the macro level. For this reason it is very important that between the bank and the company to be always a good communication and transparency in the information requested or offered, and the collaboration between these two types of organizations to carry on a partnership basis.*

**Keywords:** *bank, companies, credit relationship, real economy.*

**JEL classification:** G21, D04.

## 1. The place of the credit relationship in the financial policy of the bank and the company

From the position of financial intermediary, the banking system is an important link in the national financial system, having a significant impact on the economy in general, as it provides the financial resources that companies need to expand and grow. Mutations occurring permanently on the monetary and financial market by developing the disintermediation phenomenon, failed to diminish the crucial role that bank lending plays in the economy.

The bank loan has a special place in the financial policy of economic agents, representing one of the most commonly used ways to finance their current and/or investment activity. The causes can be found among the economic advantages enjoyed by the companies which establish credit relationships with banks:

- through the banks, the economic agents are able to access important additional financial funds over the own ones, in order to support the current projects or the long-term ones, for business development;
- establishing a credit relationship with a bank facilitates the access of the company to other products and services provided by that bank or other commercial banks;
- if the financing bank is an institution recognized nationally or internationally there is registered an increase of the company visibility in the banking system and the confidence in the viability of its business to other potential investors;
- high flexibility regarding: the amounts contracted, how to use them, the cost and terms of repayment of principal and payment of interest etc.;
- a bank loan implies a rigorous analysis made by the bank regarding both the economic and financial situation of the company and the feasibility of the project for which the funding is requested. This may determine the company's management to consider, in turn, objectively, its business, to obtain a clear picture of its financial situation and an array of weaknesses, strengths, opportunities and threats that characterize the company etc.;

Like any external source of funding, the bank loan also has a number of disadvantages for the company that contracts it, respectively:

[1] PhD, „Alexandru Ioan Cuza” University, Iași, România, bvoroneanu@yahoo.com

- the bank loan is not available to all operators and it involves a complex process, which is why companies need to draw well-founded credit files;
- the obtaining of the bank financing may be subject to submission of collateral (own ones or belonging to third parties) to secure the requested loan. There is the risk that the immovable or movable goods mortgaged in favour of the bank to be lost in case of unfulfilling the contractual provisions;
- the bank loan is a form of external financing, which means implicitly the influence of external factors on the company's management, namely the emergence of some financial restrictions;
- exposure to new risks for the company or increase the existing risk exposure: interest rate risk, currency risk, if the credit is contracted in a different currency than that of the company earnings etc.;
- risk of cancelling the credit in case of unfavourable economic situation affecting the company activity or in case of non-complying of the contractual clauses (i.e. prohibition of new disbursements from a credit line if the company records overdue debts towards other banks/ state budget);

On the other hand, in the investment policy of a bank, the companies lending is an important part, both in terms of business volume and in terms of participation to profits. Each loan can have many positive effects on the activity and the financial situation of the bank, as follows:

- first, it can be a quality investment. In this case, the bank assures reliable incomes from interest and fees on the one hand, and, on the other hand, since the risk of the loan to go in the default is low, it will not imply any expenditure growth with provisions that such risk might cause;
- second, it will be a collateral revenues generator for the bank: fees from related operations that will result (payments, foreign exchange, etc.);
- third, is a good opportunity for cross selling of the full range of products and services offered by the bank: internet banking, payroll conventions, different types of debit and/or credit cards and other lending products for company employees, saving products etc.;
- last but not least, it can be a marketing success - if the customer is a company known at regional, national and/or international level - that can turn into a business one by attracting new customers (partners or not of the financed company).

In other words, the quality of the loan portfolio ultimately depends on the bank stability and on the achieving of the appropriate levels of solvency and liquidity indicators. For this reason, the bank management pays a special attention to the lending activity, aiming, on the one hand, the making of the lending decision on rigorous analysis of the credit risk, and on the other hand, the constant monitoring and strict management of the granted credit facilities.

One of the most sensitive problems which are always found between the concerns of the theoreticians and specialized practitioners is to ensure a smooth functioning of the credit relationship between banks and companies. Management of this relationship, both from the bank and economic agent perspective, has as fundamental aims the protection of the institution investment and optimization of the cash flow.

An important function of credit relationship management is to control the loan, approached from the perspective of decision making required sizing credit, on the one hand and ensuring compliance with the terms and conditions negotiated on the other. Credit control is necessary in order to avoid lack of liquidities as a result of excessive investment and to achieve a balance between profitability and the involved risks.

It is essential for future financial and economic activity of both the company and the bank, that the financing decision to be made based on a thorough grounding in the financial management of the company and that the departments involved in the bank. The clear and transparent establishing of all the contractual terms in consonance with the real financing needs of the company and trusting communication will positively or negatively influence the conduct of the lending relationship between the bank and the company, with profound implications for the real economy.

### 2. Cases of imbalance of credit relationship between the bank and the company and the effects on the real economy

Credit relationship that arises between a company, as the applicant for a loan to finance its current activities or investments and a bank, as provider of financial capital needed involves a complex process characterized by a sequence of steps defined and regulated. Each step, from identifying the need for finance and to the administration of the exposure involves flows of information and documents, departmental interactions and above all, decisions that materialize into concrete actions, with direct effects on both the bank and the economic agent which requested that loan or commitment.

During its course, the credit relations between banks and companies may face both balance periods and with periods of stress. The main factors which may cause the occurrence of such sideslips of the credit relationship are the follows:

- specific to bank: changing of the objectives of the respective bank and of the policy regarding the lending activity in general, and the economic agents in particular. The financial position of the bank or financial group to which it belongs, the access to necessary sources of lending and their cost or certain prudential considerations are several causes that can cause significant changes in lending policy of economic agents, with direct impact on the quality credit relationship between the bank and the company;
- specific to company: a significant change in the negative sense of the economic and financial situation of the company, tensions emerged in the shareholders or top management structure, the development of commercial relations with partners that may affect the company's image, obtaining more favourable financing offers or even contracting of new credit facilities from other banks or credit institutions can make it difficult the continuation of the credit relationship in parameters initially negotiated;
- macro-economic, specific to national economy: legislative changes with direct effect on the companies lending that may force banks to reconsider certain exposures. For example, according to the new regulation of the National Bank of Romania on the conditions for granting loans in foreign currency, became applicable in the spring of this year, the companies which want to access bank financing in foreign currency must prove that they can support their contractual obligations, that can manage debt without severe consequences on their financial positions in spite of a massive depreciation of the exchange rate between that currency and national currency;
- distortions of the economic and financial flows as a result of contagion from international markets over the domestic one. Collapse of the subprime industry that triggered the financial crisis, subsequently turned into an economic, affected the national economy primarily inducing a state of mistrust between the two major sectors, banking and real one represented by companies. The results were without precedent: a general liquidity shortage, exponential growth in the number of bankruptcies and insolvencies among economic agents, drastic restructuring of the banking system, repositioning of lending policies promoted by credit institutions with emphasis on caution to the detriment of profitability etc.

A tensioned, unbalanced credit relationship primarily affects the communication, respectively the smooth flow of information between the bank and the company. Depending on the duration of the crisis, it can be a passenger event with limited effects or conversely it can worsen, its consequences having repercussions on the operational, fundamental side of the relationship. In the latter case both sides are affected, and if the situation knows a tendency to generalize (at the entire portfolio of a bank or worst case scenario, at the banking sector/ area of the real economy) its effects are reflected at macroeconomic.

The main cases of imbalance of the credit relationship between the bank and the company are the follows:

*a). Bank wants to change the initial terms (costs, period of validity and/or credit, disbursement conditions, etc.) or even to decrease or close the exposure on a company.*

If that company fails to obtain in a optimal time the required funding from another source, there is the risk that the credit relationship defined by the new conditions imposed by the bank to initially generate negative consequences for economic and financial situation of the company and possibly for the economic microclimate as far as the company is forced to rethink a more austere operational strategy to be able to continue the work:

- increasing of the prices for the products or services offered by the company;
- dismissal of a part of the employees;
- reducing of the supply with raw materials and/or goods affecting other businesses, as a chain reaction.

Depending on the size of the company, the negative effects may be more pronounced on the respective socio-economic microclimate, and in addition, it can extend to the financing bank:

- increasing of the expenses with prudential value adjustments (provisions) with a direct impact on the profitability of the institution;
- affecting the bank's liquidity ratios;
- influencing the cost of funds for lending;
- affecting the credit relationships (for prudential reasons) with other companies in the same field or have similar loan products, with all the implications that arise at both the bank and the company, the sector or the real economy.

*b). The trader requires renegotiation of credit conditions initially approved, and in case of a refusal from the bank it will refinance part/ full exposure.*

This situation occurs especially when the macro economy pass through a period of expansion and the competition in the banking market is very strong. Losing a customer can affect the bank both directly and indirectly:

• directly: bank revenues are diminished and its financial results are not as expected; the bank cannot pay sources attracted to a level that would ensure attracting new or retaining existing ones, may be forced to operate even downsizing of the unit which manages that client;

• indirectly: negative signal sent to the market that can generate new migrations of the key accounts and even of significant financial resources, with the implications mentioned above.

Depending on the impact of these negative effects on the financial situation of the bank, the consequences may be expected also on the real economy represented by those companies, clients of the bank in question, for which the lending costs and/or those related to current operations have been increased as a solution to limit or mitigate losses.

*c). Credit relationship is affected by the generalized economic and financial crisis.*

In this case the confidence is primarily affected, as vital part of the relationship between the bank and the company. Thus, economic agents fail to develop short-term strategies even being reluctant to any change in existing lending relationships or establish new ones. If there are still companies interested in new funding, their applications face with restrictive-caution attitude of banks which are especially interested in preserving liquidity and sterilizing the loan portfolios.

How the moments of crisis are overcome directly affects the quality of the credit relationship, respectively its effects on the two types of entities and in this way on the real economy.

At the companies' level:

- there are suspended the investment projects that would have meant the business development with positive implications both at their level and the afferent microclimate: creation of new jobs, increasing of consumption of raw materials, new purchases of goods, stimulating other business with chain reactions to regional or national level;
- the payment and collection terms are renegotiated affecting the cash flows of the partners with direct effects on solvency;
- the commercial credit begins to disappear generating the bankruptcy of companies for which this was the main way of refinancing;
- the operational costs increase, fact which is reflected in higher sale prices and a downtrend of consumption.

At the banks' level:

- diminishing of the incomes from interest and fees as a result of the insolvency/ bankruptcy of customers;
- there are eroded the financial results by provisioning for credit risk;
- operational costs are covered in an increasingly smaller percentage by the fees from loans and current operations, generating ample programs of layoffs and closure of branches which have become unprofitable;
- the sources of capital funds necessary for lending activity become more expensive thus increasing the costs of credit and current operations.

Summarizing the negative effects that a strained credit relationship may induce, it can be defined the following categories:

- monetary nature: growth of interest rate, increasing the rate of inflation;
- social nature: the decline in employment opportunities;
- economic: lower gross domestic product.

To avoid these negative implications for economic and social life at both the micro and macro level, it is important that between the bank and the customer always be good communication and transparency in the information requested or provided, and cooperation between the two categories of organizations to carry on a partnership basis.

## 3. Measures to improve the quality of bank - company credit relationship

Considering the credit relationship between the bank and the company being based on a processual cycle of information flows, decisions and actions, the measures to improve its quality, both to prevent further slippage and to reduce the negative effects generated by the imbalance situations take the form of measures to increase the efficiency of the steps that compound the lending process, measures which can be taken both by the financing bank and the economic agent that launches the credit request.

At the banking sector level, it is very important right from the moment of setting the companies lending strategy, *to have transparent communication from departments directly involved* because in this way the executive echelons will determine the most effective action plans to maximize benefits. If the elements of strategy are transmitted partially or the transmission has an interpretable character, it can lead to adverse effects such as:

- channelling the efforts to less productive or unproductive directions;
- affecting of the relationships with existing customers;
- initiating the inappropriate lending relationships with new clients, etc.

To improve the efficiency of the activity of identifying financing needs, it requires the creation and updating in real time of a unique database on the bank (or banking group) with information not only about existing customers but also on the target ones: the financial history, shareholding structure, exposure to other banks or other financial institutions, and how previous meetings were completed, local information about the company and/or management.

For increasing the yield of the potential customers selection process is very important that in case of the large-scale financing projects (in terms of value, complexity, disbursements particularities, etc.), *the negotiation of the financing offer to be made in the presence of the bank representatives, with decisional competence* from the business risk departments. Would be significant advantages for both sides:

- negotiating of the granting terms would be done in real time, earning the precious time that would otherwise consume with the correspondence between central and network;
- increasing the efficiency of process of credit application preparing and even approving because part of any problems or questions rose in the pre-approval period would clear during these negotiations.

A particular importance in the lending process from the perspective of a bank loan application is drawing and drafting the application. It is one of the most complex stages of the credit relationship, being critical for its good operation, because the collecting of necessary documents for composing the credit file and the preparing of the credit review require a permanent collaboration between specialized departments of each of the two entities. Increasing the efficiency and effectiveness of actions and processes that take place in this stage can be achieved by *implementing a set of principles and working practices*:

- the collecting of documents which compose the credit file to be made at the company head-quarter. A significant time saving is achieved if the documents are filled directly in the accounting department of the company. In addition it is also recorded a real gain in terms of accuracy and correctness of the information requested;
- permanent bank - company collaboration (the concerned departments) throughout the credit review preparation in order to jointly solve the negative aspects of any commercial or financial situation of the company or any doubts about the features of the requested credit product;
- adopting a fair and transparent approach by both of the parties involved in the potential credit relationship.

The most sensitive stage of the credit relationship is the management of credit facility and monitoring the contractual conditions. In this case, it is necessary to adopt measures to streamline the decision-making process which aim is *to relax any tensions in order to ensure the premises of a partnership and profitable collaboration for both parties*:

- applying a treatment customized for each credit application by avoiding generalizations;
- adopting an open attitude oriented to a transparent dialogue and to finding real solutions (and while legal) for the issues raised;

Persons involved in decision-making activity in terms of lending must be familiar with the economic reality, must possess expertise in risk management with all its implications, but also in relationship management, so that communication between the bank and the company to be as transparent and as most beneficial for both organizations.

From the economic agent perspective, increasing the efficiency of the bank loan contracting process, as a prerequisite for a balanced relationship with the financing bank, begins similarly with the clear setting of the company's strategy and objectives. The strategy regarding the covering of the financial needs of the current and/or investment activity through bank loans must be the result of the financial decision whose objective is to choose the financing structure based on the optimal cost of each source of capital analysis.

Next steps, quite similar to those seen at the bank lending process, involving complex interactions between the financial management of the company and the bank's specialized departments that directly affect the quality of the relationship between the two entities. Key measures for improvement are the follows:

- involvement in investment projects for which there is expertise in all departments of the company: production, commercial, financial, legal;
- rigorous sizing of funds needs to ensure the desired outcome;
- choosing of bank lending arrangements so that they overlap as well on the financing needs of the company;
- clear definition of the main terms of the credit facilities that are intended to be taken: amount, loan period, disbursement conditions, costs structure, reimbursement conditions, guarantees that can be provided to secure the future exposure etc.;
- compliance with legal regulations in force;
- profitability should be the main criterion for the selection and promotion of projects for which it is accessed the bank financing (aiming both the operational costs involved and any losses caused by projects failure);
- permanent awareness of the income - risks ratio specific to each of the financed projects;
- knowledge and understanding in details of the business, of the managerial and market particularities which the entity operates.

## 4. Conclusions

The social and economic development of a nation depends largely on the proper functioning of economic and financial mechanisms that facilitate the development of cash flows in correspondence with real flows that are carried out in an economy. Given the role that banks and companies have in ensuring a favourable socio-economic development of a nation, a new philosophy of the bank - company relations focuses on the implementation of team spirit between the relationship manager (bank employee) and financial manager of the company so that they can create value in the mutual interest of the parties and in this way to positively influence the macro economy going.

## References


1. Basno, C., Dardac, N. (2002), *Management bancar*, Editura Economică, Bucureşti.
2. Bessis, J. (2002), *Risk management in banking*, John Wiley & Sons Ltd.
3. Brigham, F. E., Houston, F. J. (2012), *Fundamentals of Financial Management*, Concise Seventh Edition, South Western Cengage Learning.
4. Brown, M., Zehnder, C. (2007), "Credit Reporting, Relationship Banking, and Loan Repayment", Journal of Money, Credit and Banking, vol. 39, no. 8, The Ohio State University.
5. Dedu, V., Ghencea, S., Enciu, A. (2008), *Produse si servicii bancare: corporate si retail bancar: principii si tehnici de analiza, creditare, monitorizare, trezorerie si plaţi electronice*, Editura ASE, Bucureşti.
6. Elyasiani, E., Goldberg, L.G. (2004), „Relationship lending: A survey of the literature", Journal of Economics and Business, vol. 56, pp. 315-330.
7. Gorton, G.B., He, P. (2008), "Bank Credit Cycles", Review of Economic Studies, 75, 1181–1214, The Review of Economic Studies Limited.

8. Kraemer-Eis, H., Lang, F. (2012), "The importance of leasing for SME finance, European Investment Fund Research & Market Analysis", Working Paper 2012/15.
9. Lookman, A.A. (2009), „Bank borrowing and corporate risk management”, Journal of Financial Intermediation, vol. 18, pp. 632-649.
10. Love, I., Zaidi, R. (2010), “Trade Credit, Bank Credit and Financial Crisis”, International Review of Finance, 10:1, pp. 125–147.
11. Onica, M. C. (2010), *Finanțele întreprinderii*, Editura Europlus, Galați.
12. Onofrei, M. (2007), *Management financiar*, Editura C.H. Beck.
13. Parrino, R., Kidwell, D.S. (2008), *Fundamentals of Corporate Finance*, John Wiley & Sons, Inc.
14. Trenca, I.I., 2003, „Metode şi tehnici bancare: principii, reglementari, experiențe”, Casa Cărții de Știință, Cluj-Napoca.
15. Van Horne, C. James, Wachowciz jr., M. John (2008), *Fundamentals of Financial Management*, 13th Edition, Pearson Education Limited.
16. Weill, L. (2003), *Banking efficiency in transition economies. The role of foreign ownership*, Economics of Transition, vol. 11 (3), pp. 569–592.