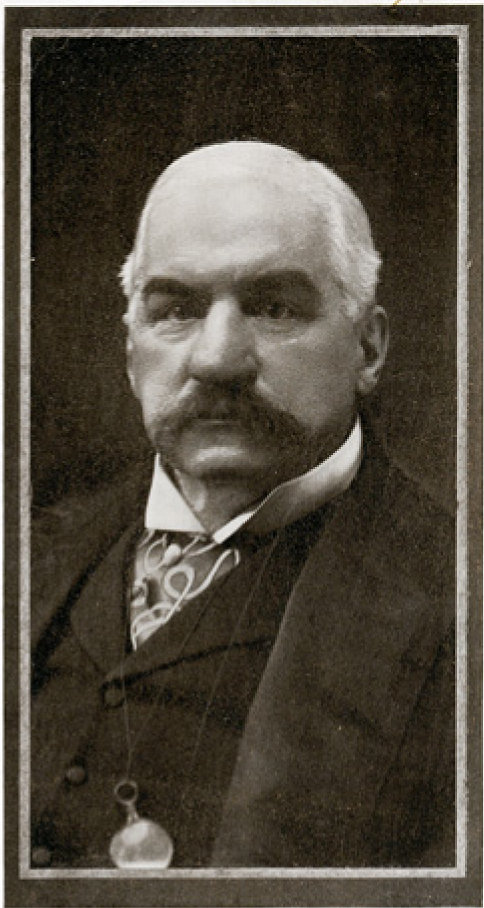
The Rise and Fall of Relationship Banking



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The transition from financial continuity and stability to market pricing for financial services

For most of the past two centuries, routine financial transactions in the business world were based on the widely recognized principles of "relationship banking." This meant, essentially, that business customers and their favored bankers generally maintained long-term linkages through a variety of financial services. Like marriage partners, customers and banks were tied together by lasting commitment. Loyalty was very important. Once a banking relationship had been formed by mutual agreement, other business enterprises were expected to keep their distance. Divorces occurred, but only rarely. These enduring relationships were often multigenerational, lasting not merely for decades but for an entire century and beyond. Moreover, in some sectors of the economy, especially in smaller communities, these commercial linkages between banks and their long-standing borrowers are still alive and well today.

Under these prevailing conditions, the efforts of competitive banking institutions to "steal away" accounts from one of their peers was seriously

frowned upon within the broader commercial community. Any attempted “theft” of accounts was especially pernicious if a rival bank offered prospective borrowers similar services at lower prices. Price competition in the banking world was unwelcome and in some quarters, even regarded as unethical. As a consequence, instances of infidelity within the world of high finance—the banking sector that catered to large and important corporate customers—were uncommon. Indeed, those bankers seeking to entice accounts away from competitors faced the potential loss of their cherished reputation for prudence and good character.

Beginning about a quarter century ago, however, these guiding principles were steadily undermined and, in time, largely abandoned. Competitive pricing for financial services became commonplace. Aggressive banks solicited business from one and all. Cold phone calls and other means of pointed communication to attract new business accounts became the norm. The justification for these marketing initiatives was that corporate customers would have the opportunity to avail themselves of superior financial services at reduced costs. Given these cost savings, large corporate customers were tempted to dissolve their long-term banking relationships. In the end, the majority finally surrendered to the advances of emboldened suitors, and relationship banking steadily disappeared. The change was especially pronounced among the largest banks and business firms, where the need to demonstrate quarterly earnings superseded long-standing banking loyalties.

To sum up before moving forward, the economic principles associated with the realization of more cost-efficient financial markets had triumphed over the previous guidelines of stability and precedent. In this altered environment, the twin goals of efficiency and stability proved, in many instances, to be mutually exclusive. Whether the steady decline of the former system of relationship banking was the prime cause of the increased volatility in financial markets during the first decade of the twenty-first century is debatable. Nonetheless, the new institutional arrangements, which championed price competition over all other considerations, were almost certainly contributing factors.

Historical Background

Relationship banking coincided with the birth of the nation’s commercial banking sector in the 1790s. The early banks were typically established by individuals with common ties—whether political, social, or commercial in nature. Banks made loans to a relatively small clientele of business customers. It was not uncommon in some areas for bank officers to arrange business loans almost exclusively for the family and friends of investors who owned stock in the bank itself. Business firms that were denied access to one bank’s lending facilities had every incentive to raise sufficient capital to start a new bank. By modern standards these banks had a small managerial staff. The bank president and his major borrowers usually knew each other very well. New

business enterprises had the chance to seek out the most favorable banking connection, but once established over a period of months or years, the linkage between a given commercial bank and its borrowing customers was essentially permanent. So long as borrowers were satisfied with the financial services offered by their primary banking connection, rival banks did not try to interfere. The interest rates charged on most bank loans were nearly identical in a given geographical area; thus, price competition was not a factor. Throughout the nineteenth century, most of the borrowers at commercial banks were wholesale merchants, farmers, and a wide range of small retail firms.

The same relationship ties existed within the realm of investment banking. Investment bankers differed from commercial bankers in that the former did not act as a direct lender but rather as an intermediary in identifying potential private investors in a company’s stocks and bonds. Investment bankers earned fees for performing this marketing service. The fee was normally anywhere from 5 to 10 percent of the value of the securities successfully marketed to investors. This financial sector was smaller than the commercial banking sector because it only dealt with larger enterprises that required substantial capital. Investment banking firms were invariably partnerships, and the partners and the executives of their corporate clients conducted prolonged and careful negotiations prior to the issuance of new securities. Corporations raised capital only at periodic intervals, often two to ten years apart. When an enterprise contemplated the issuance of another round of securities, its executives usually returned to the same investment banking firms that had served the company in the past. Outsiders recognized that the business enterprise and its investment bankers had a special relationship. The main participants in these transactions did not necessarily socialize together, but they were considered valued business friends.

“Portrait of J. Pierpont Morgan,” by Pach Brothers (New York, 1903). From “People of Note,” in The Burr McIntosh Monthly, courtesy of the American Portrait Print Collection at the American Antiquarian Society, Worcester, Massachusetts.

The investment banking sector of the economy arose at a later date than the commercial banking sector. A few partnerships emerged in the 1840s and 1850s to serve the capital needs of the railroads, but it was not until after the Civil War that the shape of the investment banking field truly solidified. For a quarter century or so, Boston and New York competed for leadership, but by the 1870s, the Wall Street crowd had become the dominant force. Investment banking was an oligopolistic sector, meaning that a handful of firms, ranging in number from five to ten or thereabouts, handled the bulk of the business. From the 1870s through the outbreak of the First World War, the U.S. railroads generated the largest volume of corporate securities and in turn were the largest clients of the investment banking industry. A clear pattern of business alliances soon

emerged: a given railroad line continued to rely upon the very same investment banking partnership decade after decade to underwrite new issues of its stocks and bonds.

J. P. Morgan & Company and Kuhn, Loeb & Company were among the leading investment banking firms on Wall Street from the 1880s forward. The partners almost never lowered themselves to solicit new business from prospective customers. Instead, they waited quietly in their wood-paneled offices for railroad executives to approach them about the best means of raising capital. Once the partners had underwritten one issue of securities for a given railroad, the same firm tended to handle all of that customer's subsequent transactions in the capital markets. Eventually, a goodly number of these transportation enterprises were grouped together and publicly known as "Morgan's railroads." Other investment banking firms had similar close associations with other groups of railway lines. Contrary to popular opinion, then and now, the partners in these investment banking firms did not invest heavily in the common stock of these railroads. One or two partners might sit on a railroad's board of directors, but their major function was to serve as watchdogs for investors. J. P. Morgan and his peers did not become deeply involved in the management of any railroad line unless it was suddenly faced with serious financial problems.

When a railroad faced bankruptcy, or the threat of bankruptcy, federal and state judicial systems sought "trustees" who were granted the authority to reorganize the financial structure in a way that seemed most likely to produce an eventual return to solvency. The trustees frequently chosen by the courts were the investment bankers who had previously floated most of the railroad's securities. Since the bankers had a long-term relationship with the railroad, they were a logical choice to implement a rescue package. The bankers were willing to serve in this capacity because they wanted to protect the financial interests of those investors who had purchased the railroad's securities on the basis of the strong recommendations of the investment bankers themselves. If the bankers did not make their best effort to repair the financial damage, then future investors might refuse to purchase any new securities issued by the troubled railroad and, more critically, the securities of other railroads sponsored by the same investment bank as well. In short, the close relationship between a given borrower and its primary investment bank typically endured through both thick and thin.

The ties between corporations and their commercial banks were reasonably similar in nature. The key difference being that the number of commercial banks within the "relationship" group could run as high as ten to twenty primary lenders depending on the size and scope of the business. A large corporation might have close links with commercial banks from coast to coast. Nonetheless, the corporation usually maintained its largest deposit balances with a single bank in any locality. The key relationship for the very largest corporations was typically with a large commercial bank in New York. The main factor to remember is that, once established, relationships endured whether singular or

multiple. If, for example, our fictitious XYX Corporation had done business for years with the same three commercial banks and a singular investment bank in New York City, then other competitors in the financial sector respected those existing alliances as essentially inviolate. Meanwhile, the majority of banks were content with the stability of these convenient semipermanent arrangements.

Triumph of Impersonal Market Forces

What eventually upset the apple cart was the movement for the deregulation of numerous sectors of the U.S. economy in the post-World War II era. In the late 1970s, both the airline and trucking industries were successfully deregulated. Competitive pricing became the norm for airline tickets and trucking rates. Financial services were likewise affected, although the changes occurred at a slower pace. Within the commercial banking sector, the previous governmental limitations on the interest rates that could be paid to personal and commercial depositors were steadily loosened. Paying interest on checking accounts as well as on savings accounts was permitted for the first time.

Within the capital markets, partnerships were permitted to reorganize as corporations, thus limiting the personal financial liability of the proprietors of investment banks. What had once been a vital hedge against risk was now lifted as investment bankers could build ever-greater risk into their companies' portfolios while remaining personally insulated from that risk. The New York Stock Exchange also eliminated its fixed commissions for buying and selling stocks. Stockbrokers could now set their own fees for a wide range of transactions, thus inducing vigorous price competition among brokerage houses. As deregulation brought greater competition for banking and brokerage services, several of the premier investment banking firms found themselves competitvely unable to adhere to the long-standing traditions of “relationship banking.” Commercial marriages soon began to falter. The most aggressive investment banks no longer refrained from approaching the customers of their peers. They offered new customers superior services at lower fees. Breaking another long-standing taboo, they advertised boldly for increased business from destinations far and wide.

Another factor that may have played an important role in the emergence of a different climate in the nation's financial centers was an unprecedented demographic and generational trend within the leadership positions. In the past, the top executive officers of both the banks and their business customers were seasoned veterans typically in their fiftiess and sixties. These executives had advanced at a slow, steady pace up the corporate ladder. Over several decades, the lending officers and their borrowing counterparts had experienced the opportunity to develop a viable commercial friendship. However, the new generation that came to power in the 1980s was devoted to more competitive pricing in financial markets. Armed in many cases with MBA degrees and demonstrating much acumen when it came to burnishing quarterly earnings reports, these younger hotshots frequently moved up into advanced executive

positions in their 30s and 40s. The new bankers saw the old-fashioned guidelines as the hallmark of thousands of unimaginative old fogies whose days at the helm had rightfully passed.

Many political figures and their economic advisors praised the renewed vigor of the allegedly more efficient financial services sector. Fearful of the potential threats arising from financial institutions in Europe and Japan, they championed the increased intensity of competition exhibited by banks headquartered within the United States.

The culmination of the deregulation movement came with Congress's 1999 repeal of the Glass-Steagall Act, the Depression-era law that had prohibited commercial banks from acting as investment banks and vice versa. Now, every bank had the opportunity to offer a full range of financial services. Bankers could arrange short-term loans to corporations in a morning meeting and then put together an underwriting deal for stocks and bonds later that afternoon. The next day the very same bankers could offer clients sophisticated advice on potential mergers and acquisitions. Free of tight rules and intrusive regulations, U.S. banks could now offer complex bundles of services that would, they claimed, greatly help their clients' balance sheets. This development further invigorated domestic and global competition in the banking sector. Social networks and cultural inclinations mattered far less when the main ingredient in crafting a deal was the bottom-line price for the services being rendered.

By the turn of the century, relationship banking in the major financial centers was mostly a relic of the past. Corporations in need of critical financial services had the option of shopping widely for the deals that seemed to serve them best at the most reasonable cost. The former universal principles of personal and institutional relationships had been downgraded to an incidental irrelevancy. Vitality had supplanted stability. The impersonal market ruled the financial realm.

In light of the worldwide financial crisis in the second half of 2008, it will be interesting to note whether current trends will continue—or perhaps on second thought the greater stability of the relationship model will undergo a sudden revival. Your guess today is as good as mine.

Further Reading:

The secondary literature on commercial banking is extensive, but the coverage of investment banking is more limited. Only rarely are these two financial sectors covered in a single volume. With respect to the shift away from relationship banking toward price-driven financial transactions, I strongly recommend Ron Chernow's *The House of Morgan: An American Banking Dynasty and the Rise of Modern Finance* (New York, 1990). See, in particular, part 3, which is appropriately titled, "The Casino Age." This volume won a National Book

Award in the nonfiction category.

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