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Abstract
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Keywords
theoretical, analysis, bank, relationship

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A THEORETICAL ANALYSIS OF BANK RELATIONSHIP

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ABSTRACT

This paper analyses the banking relationship between branch manager and loan officer of a bank branch using two theoretical approaches - Agency Theory and Trust Theory. The analysis is performed across five dimensions of the business relationship between branch manager and loan officer – supervisor subordinate relationship, delegation of authority, assumption of risk in lending, goal congruence and mutual dependence. It is concluded that Trust theory is better descriptor of the banking relationship between branch manager and loan officer as compared to Agency theory because Trust theory can explain situations involving multifaceted relationship such as one between branch manager and loan officer using stakeholders perspective.

Key Words: Trust, bank relationship, agency theory, lending, risk

INTRODUCTION

Banks have come under considerable scrutiny in the wake of recent Global Financial Crisis. Banks play a major role in the provision of credit to businesses and consumers. A bank's survival and its ability to compete in the market place depend on its ability to use its resources to earn income. The lending function of a bank is an important aspect of this income generation. This income generation from lending business will depend on the credit philosophy and management, risk management and structure of credit organisation put in place by a bank. A branch of a bank is a place where most of the lending occurs in a bank. The two most important functionaries involved in lending function of a bank branch are branch manager and lending officer. Consequently the relationship between branch manager and loan officer is crucial in determining how well the lending management of the bank branch is carried out and how well the credit risk will be managed at the branch level. The purpose of this paper is to critically examine the crucial relationship between branch manager and loan officer of the bank branch using two different theoretical approaches of agency theory and trust theory and to arrive at a conclusion as to which of the two theories is most appropriate in describing the business relationship between branch manager and loan officer. Section 2 of this paper describes the salient features of agency theory and trust theory. Section 3 describes the role of branch manager and loan officer in the lending business of bank branch. In Section 4, agency theory and trust theory are used to explain various aspects of the relationship between branch manager and loan officer. Section 5 describes the conclusions arrived about the appropriateness of agency theory and trust theory in describing the relationship between branch manager and loan officer.

THEORETICAL APPROACH

This section describes the basic principles of agency theory and trust theory. The detailed application of these theories to branch manager loan officer relationship is described in Section 4.

Agency theory

The agency relationship is based on the agency theory of Jensen and Meckling (1976, p.308). Agency theory is based on the contractual relationship between a principal and an agent, who works for a principal. There are three important elements of agency theory. First, is the existence of a contract between a principal and an agent, the second element is the performance of a service by the agent. The third element is the delegation of authority by the principal to the agent. According to Beccerra and Gupta (1999, p.184), the objective of agency theory is to design a contract between a principal and agent. Agency theory focuses on the identification of problems that may arise in an agency relationship. These agency problems are identified in the literature as problems of horizon, effort, risk preference and use of assets in the agency relationship (Byrd, Parrino and Pritsch, 1998).

Trust theory

The role of trust in business relationships has emerged as a response to the self interest and opportunism advocated by agency theory. (Bromley and Cummins, 1992; Etzioni, 1998). Trust has emerged as an alternative to agency theory because society has become critical of business values in recent years. The role of business in society is being evaluated critically these days and society finds it hard to accept the unethical dimension of business for the purpose of protecting its bottom lines. Trust is defined as "confident expectation and willingness to be vulnerable" (Valez, 2000). There are a number of approaches in the literature on trust. A psychological approach to trust concentrates on the personality traits of an individual (Rotter, 1980) whereas the social approach to trust interprets trust as "individual characteristics considered by others as trustworthy" (Dasgupta et. al, 1990). The study and use of trust requires multilevel perspective and flexibility in understanding the concept of trust as trust is considered a complex phenomenon which manifest itself at various levels of individual, group and organisation. Each of these forms of trust has different causes and may affect the people and organisations involved in trusting relationship in a different way.

THE RELATIONSHIP BETWEEN BRANCH MANAGER AND LOAN OFFICER OF A BANK BRANCH

Branch managers are the leaders and chief executive at the local level of a bank branch. Branch managers are responsible for the profitable operation of a bank branch. They supervise the deposit taking effort of a branch by evolving strategies for new accounts and expansion of current business. They monitor efforts of sales team at the branch, resolve customer complaints and evaluate the performance of deposit, lending and other teams at the branch. Branch managers also approve loan requests within their delegated authority. The approval of a loan request is done based on the evaluation of loan applications by loan officers. Sometimes branch managers also delegate their lending authority to loan officers for temporary periods or on a specific aspect of business.

The job of a loan officer at the branch level involves accepting and analysing loan applications submitted by various types of clientele – household, business and institutional. The loan officer makes initial contact with the customer, helps the customer in filling out various forms and explains to them about various products and services offered by the bank and available in the lending area of the bank branch. The loan officer helps in developing a service relationship with the customer. The loan officer also prepares a detailed assessment of the lending application. This may involve assessing the financial, legal and economic viability of the application and considerations of the risks and benefits involved to the bank in case the branch manager decides to accept the loan application. Loan officers handle sensitive documents and collect confidential information on the customers. Based on their assessment of the loan application, a loan officer may advise the branch manager on the risks and benefits of accepting a particular loan application. However, the final decision on the acceptance of a loan application rests with the branch manager as the branch manager is delegated discretionary authority on accepting or rejecting loan applications. The branch manager has to put a considerable degree of confidence in the ability of loan officer in handling a potentially risky lending business. The branch manager has to trust the loan officer if he or she wants to work effectively.

The relationship between branch manager and loan officer is multidimensional. First, the branch manager is a superior officer and loan officer is subordinate officer. Therefore, the first element of relationship between branch manager and loan officer can be characterised as a superior-subordinate relationship. Next, the business of lending to customers involves assuming risk on the part of bank. Both branch manager and loan officer responsible for lending business operate in a risky environment. Therefore the relationship between branch manager and loan officer is also influenced by the risk assumed in lending.

Sometimes the branch manager and loan officer may act independently of each other while at other times the branch manager may delegate a part of their lending authority to loan officer. When branch manager delegates part of his or her lending authority to loan officer, the relationship between branch manager and loan officer involves issues related to delegation of authority. However, any delegation can be only done within the guidelines laid down by Head Office of the bank as both branch manager and loan officer are accountable to Head Office and senior management of the bank for their decisions. Both branch manager and loan officer are agents of the bank and expected to observe the policies and procedures of the bank within the organisational setting of the bank. The organisational factors also influence their mutual relationships. Furthermore, both of them work in a group situation at the branch level along with other functionaries of the bank while performing their responsibilities to the bank. Therefore their relationship is also influenced by the environment in place at the branch level.

Because both branch manager and loan officer work for the banking organisation, they are expected to achieve the organisational performance goals set by the bank for the particular branch. There is thus a degree of goal congruence between branch manager and loan officer. If the organisational goals set for the branch are achieved, then both the branch manager and loan officer could benefit from the success and if the goals set for the branch are nor achieved then both branch manager and loan officer could face problems in their career. It is therefore in the interest of branch manager and loan officer to have a common approach towards achievement of organisational goals.

From the above discussion it can be seen that the relationship between branch manager and loan officer is multifaceted. In the next section this relationship is analysed using the two theories of agency theory and trust theory.

ANALYSIS OF THE RELATIONSHIP BETWEEN BRANCH MANAGERS AND LOAN OFFICERS

In this section, the relationship between branch manager and loan officer is analysed across various dimensions of their relationship to determine if agency theory or trust theory is more effective in explaining this multidimensional relationship. This analysis is performed across five dimensions of relationship between branch manager and loan officer as discussed in previous section 3. These are: supervisor subordinate relationship, delegation of authority, assumption of risk in lending, mutual dependence and goal congruence. In Section 4.1 the supervisor subordinate relationship between branch manager and loan officer is analysed.

Supervisor subordinate relationship

The first element of relationship between branch manager and loan officer is one of a supervisor-subordinate. The branch manager is responsible for overall supervision of the branch including lending business of the branch. However, the branch manager as supervisor is dependent on the performance of the loan officer who usually reports to him or her directly. Thus, the branch manager's effectiveness in achieving organisational lending goals assigned to him or her is contingent upon the ability and effectiveness of the loan officer. Similarly, the loan officer is dependent on the branch manager who is his or her supervisor for promotion, career development, provision of resources, feedback and problem solving at the work place.

This relationship between branch manager and loan officer cannot be termed a principal and agent relationship because the loan officer is not an agent of the branch manager nor the branch manager is principal. Both branch manager and loan officer work for banking organisation. Any terms of interaction between branch manager and loan officer is set by the Head office of the bank and not by mutual negotiation or contract. In some cases the branch manager may not have a choice in selection of the loan officer. In some other situations, a bank's policy may require that loan officers are appointed to the position by rotation from the group of officers available in the branch. The agency theory is not very useful in describing this aspect of relationship because no principal and agent relationship exist between branch manager and loan officer. Agency theory does not deal with situation of a supervisor subordinate working in an organisational situation. In the case of a branch manager loan officer relationship, although both work on the lending management of the branch, there is no direct explicit contract between the two which could fit into the description provided by agency theory.

The relationship between branch manager and loan officer is one of supervisor- subordinate because of the inequality of their position in the bank branch. In a supervisor- subordinate relationship trust can be used to describe interpersonal relationship. According to Jennings (1971) trust by superior is an essential condition of the promotion of a subordinate. Gabbaro(1978) found that trust by subordinate is an essential condition for effective action by a superior. Trust by manager is essential if the loan officer wishes to progress in organisational hierarchy and trust by loan officer is an essential condition for producing effective lending performance of the branch. According to Butler (1991, p.647) trust is an important aspect of interpersonal relationship and important to development of managerial careers. Agency theory assumes distrust between a principal and an agent. Trust Theory helps in describing the mechanism by which branch managers and loan officers can develop their managerial careers and improve organisational outcomes.

Delegation of authority

The relationship between branch manager and loan officer involves delegation of authority by branch manager to loan officer. The delegation may be for a temporary period of time or may be for specific tasks such as particular classes of loans or particular limits on loans.

Agency theory interprets this delegation as a governance mechanism between principal and agent that will ensure efficient alignment of the interest of the principalwith agent's interests. The agent is expected to serve the interest of principal in delegation of authority. (Eisenhardt, 1989). But the agent works for the principal under certain constraints only (Beccerra and Gupta, 1999). The first constraint is known as participation constraint when the agent agrees to work for the principal. The second issue is about the incentive constraint when the agent needs to work for the principal despite disutility of the work for the agent. These constraints of agent are reduced by contracts between principal and agent which would provide incentive to agent by reducing the attitudinal differences between principal and agent. The second way is for the principal to monitor the behaviour of agent directly. The costs incurred by the principal in providing incentive to agent and monitoring their behaviour are called agency costs. The agent on their part incur bonding costs which help them in demonstrating commitment to principal and guarantee the principal that the agent will not take any actions that could contravene their duties to the principal.(Hill and Jones, 1992). The agency theory focuses on the selection of appropriate governance mechanisms which will ensure that principal's interests are aligned with those of agent's interests. This is achieved by developing outcome and behaviour based contracts between principal and agent.

Agency theory interprets the opportunism of agents as being one of self interest (Williamson, 1975). The expectation is that economic agents such as branch managers and loan officers may disguise, mislead, distort or cheat as they partner in exchange. The opportunistic behaviour of agents may prevail in agency relationship because of adverse selection or moral hazard (Wright, 2001, p. 415). This is a very negative interpretation of human economic behaviour. In a branch manager-loan officer relationship such an opportunistic behaviour may not take place because both branch manager and loan officer have their fiduciary duty of professional conduct towards their organisation, customers and towards each other. Further, in a branch manager-loan officer relationship the kind of self interest demonstrated by agents do not exist as the organisation rules, policies and practices address the nature of relationship that will exist between branch managers, loan officers and others.

Trust theory provides a positive expectation of the individual's economic behaviour. Barber (1983) puts forward the sense of fiduciary duty placing the interest of others before the interest of person being trusted as being found in each person engaged in a relationship. Zand (1992) define trust as willingness of a principal to increase his or her vulnerability to the action of agent whose behaviour they cannot control. Trust theory supports the willingness of one person to be vulnerable to the actions of others in an interpersonal relationship.

Both branch manager and loan officer are vulnerable to the actions of each other in their lending relationship. The opportunity for the loan officer to disguise, mislead or distract is minimal as banks have internal control mechanisms in place to observe such kind of behaviour. Furthermore, the interests of branch manager and loan officer are aligned with each other as both of them wish to achieve organisational goals, which would help them further their careers. In a branch manager loan officer relationship the incidence of agency costs does not exist as the dependence between branch manager and loan officer is mutual. In a relationship involving mutual dependence, trust is a better descriptor of relationship as compared to agency theory (Michaelis, 1990, p.620).

Assumption of risk

Lending is a risky business as the outcome of any loan remains uncertain till the loan is repaid with interest. Both the branch manager and loan officer assume risk on behalf of the bank when they lend to customers. Lending business depends on assumption of risk. Agency theory assumes an agent to be risk averse and expects agents to exhibit risk-averse behaviour. Deviations from this risk-averse behaviour are considered abnormalities and distortions that are exceptions. Byrd, Parinno and Pritsch (1980) have observed a differential risk preference problem between principal and agent. This problem arises when an agent believes that his/her responsibilities for poor performance are greater than his or her benefits received during good performance. This belief motivates agents to take less risk. The evidence provided by Berger and Ofek (1994) indicates that agents reduced the risk by using diversification and acquisition of low risk assets. Mayer, Davis and Schoorman (1995) have provided a close connection between risk and trust. According to them, the existence of trust allows an individual to accept risk and become vulnerable to other party. According to Beccerra and Gupta (1999) in trusting others we assume risk and become vulnerable to the actions of others. Agency theory relies on risk aversion whereas trust theory considers assumptions of risk as an inherent part of relationship. Since the relationship between branch manager and loan officer requires assumption of risk in lending, trust theory is considered a better descriptor of branch manager loan officer relationship as compared to agency theory.

Goal congruence

Branch managers and loan officers have similar goals of improving lending performance of a bank branch because the career progression of both branch manager and loan officer depends on their ability to improve the lending business of the branch. Thus goal congruence exists between branch manager and loan officer.

Agency theory assumes that a conflict of interests exists between principal and agent in agency relationship. The principal derives financial benefit or costs from agency relationship. The agent not only derives pecuniary benefits but also non-pecuniary benefits or costs from the relationship. The non-financial rewards are consumed by the agent at the expense of the principal. A goal conflict exists between the principal and the agent because of different utility functions of principal and agent. The agent's decisions are considered costly to the principal. According to Jensen and Mecklin (1976) some agents may be work averse and resort to avoiding work in order to lower their disutility associated with such effort. The agency theory assumes goal conflict since shirking of work by the agent is detrimental to the interest of principal.

Trust Theory supports a goal orientation between the trusting party and trusted party such as branch manager and loan officer. McClelland (1960) disputes the assumption of goal conflict and explains that agents may enjoy performing responsibility because of their personal need of achievement. Under such circumstances, the agents may not mind exerting extra effort in their work. According to Barber (1983) when there are expectation of technically competent role performance between principal and agent, agents may want to exert extra effort. One such technically competent role is performed by loan officer in analysis of lending proposals at the bank branch. Carnevale et. al (1992) consider trust to be essential for achieving mutual cooperation and goal congruence and benevolence of trusted party towards trusting party. According to Hosmer (1995) trust is willing cooperation with expectation that benefit will result from that cooperation to both parties involved in trust relationship. The purpose of trust is to increase cooperation and facilitate potential for joint cooperation. The relationship between branch manager and loan officer can be described as a trust relationship because both have goal congruence in their mutual desire to improve the lending performance of bank branches. This improvement in lending performance is achieved by mutual cooperation between them. They also use technical skills and knowledge involved in the analysis of lending proposals and lending initiatives.

Mutual dependence

The relationship between branch manager and loan officer is one of mutual dependence because both branch manager and loan officer depend on each other for achievement of organisational goals. The branch manager gives a mandate to the loan officer who performs all functions of assessment, information gathering, preparing credit report and analysing the loan application. The final responsibility for accepting or rejecting loan applications or making decisions about varying the terms and conditions of a loan still rest with the branch manager. The loan officer while acting on behalf of branch manager must protect the interest of branch manager and the bank and coordinate all the activities with the branch manager in dealing with customers, Head Office and other stakeholders. The branch manager depends on the loan officer to manage the lending portfolio of the branch. The loan officer is dependent on the branch manager for proper supervision, for providing support in discharging his lending work, provision of physical facilities, promotion, recommendation to higher authorities and career development.

Agency theory is not a useful descriptor of relationship where dependence between players is mutual. Agency theory focuses on the relationship in which one player has certain economic obligations which are performed for another economic actor by virtue of their relationship. The principal is dependent on the agent for performance of business outcomes. The performance of the agent towards principal is considered as a single component of relationship which determines the quality of principal agent relationship. However, the lending relationship between the branch manager and loan officer is multifaceted unlike a principal agent relationship. Trust theory takes into consideration these multifaceted aspects of relationships into consideration through stakeholder’s perspective. Shankman (1999) has argued that it is in the interest of principal to develop a trusting relationship with the agent because it helps in reducing the amount of resources towards monitoring of agent. In a lending situation there are a number of stakeholders in business who deal with branch manager and loan officer. These stakeholders are able to influence the relationship between branch manager and loan officer. Trust theory takes into consideration the stakeholder’s perspective in the relationship whereas Agency theory refers to direct dependence between principal and agent. The relationship between branch manager and loan officer may be termed one of deep mutual dependence because both branch manager and loan officer face risk due to their trusting behaviour and both are exposed to risk due to external environment.

The first component of risk in the branch manager-loan officer relationship could be one of information asymmetry where a loan officer could be keeping information received through the customers from the branch manager doing loan management work in a way suitable to himself or herself or putting pressure on the staff or customers to obtain an outcome which a loan officer thinks is good for himself or herself. The second risk could arise when a loan officer may neglect to document all the collected information on a loan application or may not properly evaluate a loan application according to policies and practice of the bank.

A risk for loan officer could arise when the branch manager who is in authority determines the job assignment to loan officer, which could be detrimental to the interests of loan officer or the branch manager may not recommend a loan officer for promotion. The risk of abuse could result in workplace harassment of loan officer. The loan officer could also face a risk to his self esteem from the behaviour of branch manager. The risk to self esteem could occur through adverse feedback received from third parties in the branch on loan performance or relationship with the branch manager.

The branch manager and loan officer have mutual dependence and face mutual risks through each other’s behaviour in the relationship. This mutual dependence is described by Trust theory through a stakeholder’s perspective. Agency theory is not able to describe this relationship satisfactorily. Furthermore, branch manager and loan officer are not just dependent on each other but also dependent on other stakeholders in organisation for proper performance of their lending function. Their relationship is linked to organisational factors and contributes to organisational effectiveness. This relationship is better understood as discussed above, in its multifaceted form determined by trust theory.

CONCLUSIONS

This paper has analysed the banking relationship between branch manager and loan officer using two theories – Agency theory and Trust theory. The analysis has been performed on five dimensions of relationships – supervisor subordinate relationship, delegation of authority, assumption of risk in lending, goal congruence and mutual dependence. Through the discussion given above it is concluded that Trust theory is better able to describe this relationship as compared to Agency theory for the following reasons. First the relationship between branch manager and loan officer is multifaceted. In a multifaceted relationship, Trust theory is better able to describe the relationship as compared to Agency theory through stakeholder's perspective. Secondly the lending business is a risky business and branch manager and loan officer assume risk in lending business. Agency theory assumes risk averse behaviour on the part of agent and principal. Trust theory relies on assumption of risk in business. Trust theory is therefore more useful in branch manager and loan officer relationship. Again the branch manager and loan officer have a supervisor subordinate relationship. Trust theory is better able to explain the relationship between supervisor and subordinate as compared to agency theory which relies on a contract between principal and agent. Finally, Agency theory assumes a goal conflict between principal and agent whereas branch manager and loan officer work for a common goal of improvement of lending performance of the branch. Trust theory is better able to explain the situation of goal congruence between branch manager and loan officer.

This paper is however limited by the fact that only one particular aspect of banking relationship – the lending relationship between branch manager and loan officer is considered for this analysis. This study of banking relationships can be extended to other forms of relationships in business of banking such as relation between bank and customers, relationship between different stakeholders in a bank particularly staff and management. The study of bank relationships has become important in the aftermath of Global Financial Crisis because banks have come under considerable pressure due to the crisis. The conventional methods of risk management based on statistical models have proven to be inadequate in dealing with the problems faced by banks. It may therefore be necessary to understand other forms of bank behaviour based on relationships to determine how banks may behave in normal and crisis situations.

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