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Understanding the Role of Bank Relationships, Relationship Marketing, and Organizational Learning in the Performance of People's Credit Bank

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Chapter 1
STUDY OBJECTIVES

Chapter one explains the objectives of the study, which are to address five research questions. The research questions are derived from one general research issue, which is the point of departure of the whole study. The research took place in Central Java with special attention as a unit of analysis given to licensed BPRs and BPR clients, as the main empirical data sources. The chapter covers four sections: section 1.1: introduction, section 1.2: bank categories in Indonesia, section 1.3: research questions, and section 1.4: scope of the study.

Section 1.1 provides a background of the study that is the foundation or the inspiration which motivated this research study. In the imperfect financial market, banks and bank clients have been complaining since the credit allocation is not optimal. It happens due to the presence of asymmetric information. Having a good bank-client relationship is believed to be able to partly overcome this problem. Moreover, in the increasingly competitive financial market, bank management needs to establish a competitive strategy to prevent client exit to a competing bank through a relationship marketing concept. Besides that, organizational learning also plays an important role in organization knowledge renewal by managing tacit information that enables an organization to find new ways in order to survive and succeed in new situations.

Section 1.2 illustrates the kinds of bank in Indonesia which consist of (a) commercial banks and (b) special credit banks, or BPRs. The Indonesian government maintains a dual banking system by permitting the co-existence of both (a) conventional banks and (b) sharia banks. The unit analysis of the survey is limited only to licensed BPRs and clients, while the in-depth study uses a limited number of licensed BPRs with an embedded unit of analysis which focuses on the processes of bank-client relationships. BPRs are not homogeneous; they consist of conventional and sharia, old and new, privately owned and local government owned BPRs.

Section 1.3 formulates five research questions, which are based on theoretical and empirical studies on bank relationships, relationship marketing, and organizational learning concepts. Although some researchers relate these concepts to firm performance, each of their studies tends to go in its own way. This research attempts to integrate these concepts into a set of hypothesized models to fill the gaps or voids from existing studies. The set of hypothesized models are the (a) bank performance model and (b) client intention to leave model to help banks anticipate and prevent client exit that will likely improve bank performance. Sustainable bank performance is also a precondition to reach optimal credit allocation, which will be beneficial

for banks, bank clients, and the society at large. This section explains the contribution of this study to the existing body of literature in the above field of interest.

Section 1.4 is a bird's eye view of the whole study. This study consists of 10 chapters that are directly or indirectly interrelated. The linkage between chapters will be explained in a diagram of the chapter structure at the end of this section (Figure 1-1).

1.1. Introduction

In general, low-level income categories of either micro, small and medium enterprises (SMEs), or households complain that they are unable to gain access to bank loans. Some inhibiting factors such as collateral, transaction costs, asymmetric information, etc., limit their accessibility to bank loans. The accessibility of SMEs to formal credit has been a major instrument in promoting equitable growth and poverty alleviation in Indonesia (Seibel and Parhusip, 1998). It is confirmed from various empirical studies in Indonesia by Berry et al. (2001) that entrepreneurs do not generally complain about high interest rates, but they do consider access to formal credit a major constraint. The problem is not simple as the root of the problem is related to asymmetric information. Micro and small and medium sized enterprises (SMEs) are more problematic than big sized businesses from an informational perspective. Only a few of them have historical records of their business activities. Berger and Uddel (2001) see SMEs as informationally opaque businesses. Besides them, banks, as credit suppliers, also complain. Asymmetric information as an element of market imperfection makes credit allocation not optimal. In credit investigations, banks find difficulties in differentiating between creditworthy and non creditworthy potential clients. An immediate implication of asymmetric information is an adverse selection and moral hazard problems, which then increase credit risks for banks. The theory suggests that small borrowers and banks can mitigate this problem by building strong relationships between each other. Repeated exchanges between a bank and its clients, both depositors and borrowers, can create close relationships that can potentially reduce asymmetric information problems.

The discussion of this matter boils down to the topic of financial intermediation. Current discussions and research interests about financial intermediation are about market failures. A market failure occurs when a competitive market fails to bring about an efficient allocation of credit. Credit markets diverge from an idealized perfect market because of transaction costs, asymmetric information, and financial risks. Allen and Santomero (1998) argue that the traditional theories of intermediation, which are based on transaction costs and asymmetric information, should be included with risk management to facilitate the risk transfer mechanism.

Stiglitz and Weis (1981) conclude that asymmetric information leads to credit rationing undertaken by banks. This may cause under-investment of SMEs, unless they are able to internally finance a generated cash flow. Credit rationing is one way to minimize credit risk driven by overstated loan proposals by loan applicants. In fact, Bank Indonesia (central bank) indicates that credit to SMEs remains below 10% of the total outstanding credits (Berry et al. 2001). Besley (1994) posed a discussion question: "How do market failures justify [government] interventions in rural credit markets?" Interventions in rural credit markets in developing countries are common and take many different forms. Credit programs and/or subsidized credits are used as standard policy measures in many developing countries.

For over 20 years, the Indonesian government has been improving the supply-side of credit through a series of deregulation packages. In 1983, maximum interest rate limitations were abandoned, reducing interest rate subsidies and letting the market set the appropriate rate, while simultaneously introducing discount window facilities in the open market operation (OMO) policy. It was followed by a series of financial reform packages from 1988 and onward, such as promoting fair competition in the banking industry by allowing new entry and reducing strict segmentation between state and private banks. One important element of the banking industry after the 1988 deregulation package is the presence of small banks, the so-called licensed BPRs[1] that have had to compete in the financial market arena since they were established. From 1988-1997, about a decade, the number of commercial bank head offices had increased by more than 100%, but after the crises the number is decreasing since the bank closures. Prior to the crisis (Table 1-1), commercial banks had 239 head offices; then by December 31, 2003, it had been reduced to 138 head offices. It meant that they were reduced by 101 banks (decreased by 42%). While on another side the total number of BPRs increased until the peak in 1999 that reflected 2,427 head offices

Table 1-1: Number of Indonesian Commercial Bank and BPR Head Offices as per December 31, 1996-2004

No.	Type of bank	1996	1997	1998	1999	2000	2001	2002	2003	2004
I	**Commercial**									
	Head office	239	222	206	164	151	145	141	138	133
	Total office	7,314	7,303	7,661	7,113	6,768	6,785	7,001	7,730	7,989
II	**BPR**									
	Head office	1,992	2,140	2,262	2,427	2,419	2,355	2,141	2,141	2,164
	Total office	n.a.	2,319	2,485	2,482	2,482	2,482	2,747	3,299	3,454

Source: Bank Indonesia annual report 1996/97-2004

[1] BPR stands for Bank Perkreditan Rakyat, which literally means People's Credit Bank. Bank Indonesia defines it as a rural bank.

By 2003, there were 2,141 head offices or a reduction of 286 head offices (decreased by 11.8%).The decrease in the number of BPRs was a serious problem. Another urgent problem was the efforts made to accelerate economic recovery in real sectors, especially SMEs which were treated as a strategic sector for three reasons, including: (1) according to Statistical Bureau 2002 data, the total number of SMEs was 41.3 million, about 99% of the total business units in Indonesia, (2) it absorbed 76.55 million laborers or more than 90% of the total workforce, and (3) it contributed to 55.3% of the GDP. The government sees SMEs as survivors and saviors of the economy during the heavy crisis, so their access to credit should be eased.

In supporting the interest of the government, Bank Indonesia took part to (1) push commercial banks and BPR to increase the distribution of credit to SMEs, (2) especially Bank Indonesia, which had formulated a BPR development strategy in order to be sustainable in serving SMEs. BPRs are admitted to have some superiorities, which are: (a) the location of a BPR is near to SMEs, (b) the credit procedures are simpler, (c) it prioritizes a personal approach, and (d) it is more flexible[2].

Although the government had a favorable impression of BPR, the BPR association (Perbarindo) still complained about unfair treatment towards BPR. Sony Hartono, the chief of Perbarindo (2002), stated the policy had pushed commercial banks to penetrate the BPR market. Harsono (2003) also claimed the government passed more favorable banking regulations for commercial bank rather than BPR. This bias can be seen since in the crisis era more than Rp. 500 trillion of government funds were for restructuring failed commercial banks.

The government seems to employ the “too big to fail policy”, in which most of its resources are heavily deployed on the large bank problems. BPR directors have felt dissatisfied, as they believe they are “forgotten” as financial institutions that adhered to marked-based operations up to the financial crisis.

BPRs are not homogeneous in terms of ownership and date of establishment. In Central Java there are at least two important categories of BPRs: (a) those owned by local governments, in which there was actually a conversion from non-bank financial institutions, which are now under the common name ‘BPR-BKK’, and (b) those owned by private parties established after the 1988 regulations. The latter category tends to be “urban based”, since the bank offices are built as close as possible to “urban economic” activities. The location of BPR operations and ownership may affect the perception toward governmental policies.

[2] Summarized from various sources as annual reports of Bank Indonesia from 1996-2003 and workshop discussions related to BPR, as in Salatiga (2002), Semarang (2002 and 2003)

The microfinance market has become much more competitive. BPR managers, the BPR association, and policy makers take pride in the competitive advantage of BPR, that is, its ability to reach timely credit application decisions. However, commercial banks use low interest rates as a competitive weapon. To compete with their low cost strategy, BPR should increase its efficiency. In accordance with this, Sony Harsono added one dimension of BPR development strategy increase efficiency in the near future.

As a matter of low cost strategy, the benefits of a relationship as a form of social capital have never been mentioned. For example, bank relationship could decrease transaction costs and all at once provide an opportunity to create sustainable performance for BPR. The elements of a relationship are intangible resources which had not gotten any consideration in previous banking research in Indonesia. This study focuses on the bank relationship, relationship marketing, and organizational learning in order to overcome market imperfections, especially asymmetric information, so that they can create sustainable performance for banks. The durability of BPR, hence the sustainable performance of BPR, will be beneficial to both BPR and its clients.

1.2. Bank Categories in Indonesia

To answer research questions in section 1.3., a sample was drawn from approximately 150 licensed BPRs during the field survey, and some of them were selected for a further in-depth study (case study). Since BPR is generic name of a diverse collection of microfinance institutions under the supervision of Bank Indonesia, directly or indirectly, it is necessary to clarify what really means by the BPR. The interpretation of BPR from a regulatory perspective, especially Bank Indonesia, changes from time to time. For instance, the BPR classifications in the 1997/98 and 1998/1999 annual statistical reports of Bank Indonesia are as follows: BPR-BKD, BPR-LDKP, and BPR non-BKD. The BPR non-BKD consist of BPR prior Pakto (old style) and BPR post Pakto[3] (new style).Since 1998/1999, Bank Indonesia Jakarta has registered two sub-categories of BPR i.e., BPR BKD (rural credit agency) and non-rural credit agency. Bank Indonesia classifies both sub-categories as rural credit banks. The BPR which is the unit of analysis (observation) is the BPR non BKD or licensed BPR, which must fulfill the required minimum paid up capital as explained in Table 1-3. The licensed BPRs cover conventional and sharia, old style and new style BPRs (Table 1-2). As per December 31, 2003, the numbers of banks in conjunction with these categories are as listed in Table 1-2.

[3] Pakto stands for Paket Kebijakan Keuangan dan Perbankan Oktober 1998, the financial and banking deregulation package of October 1998, a set of regulation to entry barrier relaxation of financial institutions.

Table 1-2: Types of national level licensed banks by size and scope and mode of operation as per December 31, 2003

	Category	Size and scope of operation		Total
		BPR	Commercial	
Mode of operation	Conventional	2,057	136	2,193
	Sharia	84	2	86
	Total	2,141	138	2,279

Source: Annual report of Bank Indonesia 2003 (the table is arranged by the author)

Under a legal and regulatory framework, financial institutions in Indonesia consist of deposit-taking or depository institutions (banks) and non-depository (non-bank) institutions[4]. Banking Act No.7/1992, March 25, 1992, and its amendment Act No. 10/1998, November 10, 1998, classify banks into two broad categories in terms of size and scope of operations. This classification seems to be similar with German banking classifications, i.e. (a) universal banking and (b) special credit banking (Howells and Keith 2002). A universal bank is similar to a commercial bank, and a special credit bank is similar to Bank Perkreditan Rakyat (BPR). The banking acts also accommodate the recent Moslem community aspirations by implementing a dual banking system. This system is basically based on the modes of operations of the banks, in which two additional categories are in the financial marketplace. They are the sharia bank and conventional bank.

The universal or commercial bank provides general banking services with access to a payment system and may also involve foreign (currency) exchange services. The bank can provide a full range of banking services and engage in a mix of retail, wholesale, or corporate banking. The BPR is a small sized bank in terms of initial paid-up capital requirements. However; the small-bank is not a "scaled-down" version of a large bank. Because BPR is not allowed access to a payment system, it does not offer checking accounts and foreign exchange facilities. Before the central bank decree of 1999, the regulation also limited BPR operations within a district, and the branch locations were limited to the adjacent districts of their head office locations and the districts were not a part of the capital city[5]. As an intermediary institution, BPR's main role is fund mobilization by receiving time deposits and savings deposits and extending loans to its clients. In short, BPR, as the name implies, specializes in retail banking and small sized loans to the lower business and community classes at large and is

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[4] The non-bank financial institutions are comprised of two stock exchanges, multi finance institutions (leases, venture capital, consumer loans, factoring, credit card), pension funds, insurance, savings and credit cooperatives, etc

[5] It is assumed that regulated transferred rural banks should stay in rural areas only, regardless of their SME and low income household clients, which may be spread around rural and urban regions.

therefore belonging to a microfinance institution (MFI). From a historical perspective[6], diverse deposit taking MFIs have been in operation for a long time. Apart from these two banking acts, the government issued regulation no. 71/1992, which imposes strict option to all deposit receiving MFIs that they must convert to either a BPR or a cooperative; otherwise, they are not allowed to receive any kinds of community deposits.

BPR, as a generic name of a micro bank, has three options of a legal entity i.e. limited liability (PT), regional company (PD), and cooperative (Kop). Most new BPR establishments choose to be limited liability companies**.** According to the legal entity, the BPR distribution consists of 62% limited liability companies (PT), 35% regional companies (PD), and the remaining 3% as cooperative companies (Coop). It is estimated that 382 BPR units of the BPRs in Central Java (around 65%) are regional local government owned BPRs.

BPR is labeled as a *rural bank;* its name is implicitly self-explanatory, where the bank operations were confined locally in district areas characterized by a rural economy. Nowadays, by definition, BPRs may not be best characterized as rural banks anymore. After the new central bank decree in 1999, BPRs are allowed to stay in either urban areas or rural areas. The major shift in BPR location policy is a result of a longstanding negotiation among interest groups such as the Indonesian government / Ministry of Finance, Bank Indonesia versus BPRs associations, and others. The sound reasons underlying the location shifts are: (a) the natural tendency of BPRs to open their offices close to the capital city or in a district area with urban-like economic conditions, and (b) BPRs serve poor people or the lower-level income class that is spread over the rural and urban areas. The urban areas are even becoming more desperate facing a wider gap of income distribution. Most importantly, the poverty of people in the urban areas is more visible than that of people in the rural. The gap between the poor and the rich is more discernible in the urban areas. Although commercial banks disburse a portion of their credit to the urban poor, their scale of economic operations and the "elitist style" of their service inhibits them from gaining access to commercial banks. At the same time, BPRs can serve the lower income class at the community level with micro credit that has specific attributes and services they really need. It is important to note (Wall Street Journal Europe, November 27, 2001) that micro credit is an idea everyone can agree on: it is granted by private enterprises, it can be profitable, and it gets money straight to the poor. Bridging the gap between rich and poor will help eliminate conditions of despair and hopelessness that breed violence and extremism. According to the bank-client standards, BPRs can serve the poor better than commercial banks.

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[6] Steinwand (2001) provides a more comprehensive historical review of the BPRs.

Since the serious financial crisis following the banking system failures in 1998, Bank Indonesia set a higher barrier to entry in the banking industry by increasing paid up capital (Table 1-3) and other restrictions to new entrants. As a result, only new banks that meet higher quality standards can enter the banking industry. From 1988 to 1998, the required paid-up capital of new commercial (primary) bank establishments was equal to 200 times paid up capital of a secondary bank. Since the aftermath of the banking crisis, in May 1999 a new paid up capital for commercial banks increased significantly by almost 300 times as much as in 1988 Therefore, one new commercial bank establishment required as much as 1,500 to 6,000 times in initial capital for new BPRs. Regardless of the fact that the required initial capital of BPR increased by 10 times (in rupiah denomination) or approximately 2.5 times (in US$ denomination) within a 10 year period, the entry barrier is still open to new entrants. Apparently, the new regulation makes entry more difficult for primary banks that for secondary banks.

New shareholders must fulfill minimum capital requirements before their BPR can be put into operation, while the existing BPR shareholders can fulfill the minimum required capital in stages, that is 40% by December 31, 2006, 70% by December 31, 2008, and by December 31, 2010, 100% of the capital must be fulfilled. In terms of capital requirement, the distinctions between BPRs and commercial banks are not only in the magnitude but also regarding location-dependent and location-free restrictions (Table 1-3).

Table 1-3: Location-dependent minimum paid-up capital in establishing new BPRs and location-free commercial banks in 1988, 1999, and 2004

No.	Bank category	1988		1999		2004	
	Location	Rp. mil.	US $000	Rp. mil.	US $000	Rp. mil.	US $000
A.	Commercial bank	10,000	5,931	3,000,000	419,580	3,000,000	315,789
B.	People credit bank						
1	Region I	prohibited		2,000	280	5,000	526
2	Region II	prohibited		1,000	140	2,000	211
3	Region III	prohibited		500	70	1,000	105
4	Region IV	50	30	500	70	500	53
RATIO A/B	High (x)	200	200	6,000	6,000	6,000	6,000
	Low (x)	200	200	1,500	1,500	600	600
Exchange rate (US $1=Rp.)			1,686		7,150		9,500

Source: Decree of Bank Indonesia and the Minister of Finance
Note : Region I represents Indonesia's capital city, Jakarta. Region II represents the provincial capital cities of Java, Bali, and regency capitals adjacent to Jakarta (e.g. Tangerang, Bogor, and Bekasi). Region III covers provincial capitals outside of Java and Bali. Region IV covers capital cities of regencies for the rest of Indonesia.

To screen out the best quality of new entrants in the banking industry, additional entry barriers of non financial measures have become more restrictive.

1.3. Research Questions

The important roles of small and micro enterprises as a backbone of economic development are almost unquestionable. Furthermore, in line with this statement an observation undertaken by some international consultants of the Indonesian government revealed that in the aftermath of the economic crisis, the awareness of the role that small and medium enterprises (SMEs) have as being 'the backbone' of the Indonesian economy has increased (ADB, 2001). Notwithstanding the increasing attention and effort, questions clearly remain about the adequacy of access to external fund sources. Several studies on small financial businesses indicated that small businesses are affected by imperfections in financial markets, and so suffer a disadvantage in obtaining external funds compared to larger companies (Lopez-Gracia and Aybar-Aias, 2000). Such conditions reflect a *barrier to small business lending*. Directly or indirectly, the Indonesian government intervenes in the small business loan market to promote SMEs in gaining access to credit. This issue is not only faced by SMEs but also banks. It is agreed that banks need to continue exercising a degree of prudential banking practices, while still striving to fulfill small business credit needs.

When facing a financial crisis, there is a growing concern that small firms may find difficulty in acquiring bank credit. A financial crisis might be followed by bank consolidation, bank mergers and acquisitions, or bank closures that will reduce the amount of credit. Ultimately, a reduction in the amount of credit will probably reduce credit availability to small businesses (Jayaratne and Walken, 1999). Berger and Udel (July 2001) are also concerned with the impact of shocks to the banking system on the availability of credit for small businesses and its effects on the lending relationship. This phenomenon existed in Indonesia during the 1997-1998 economic crisis. Consequently, the durability of a bank or the sustainable performance of a bank became important for both sides. A relationship network or dyadic relationship is one of the indicators of social capital[7]. The relationship concept is a common element of the three main concepts of this study that is highly likely to create net benefit (or value) among the parties through repeated exchange transactions, such as (a) reducing transaction costs, (b) facilitating knowledge/information transfer and innovation, (c) promoting cooperation, (d) improving

[7] Social capital is an interesting topic, as it can enrich the theoretical and empirical body of knowledge; however, it is beyond the study of this framework.

optimal credit allocation, etc. A bank and its clients benefit from the value of having a long term relationship. Considering the points above, the general issue of this research is formulated as follows:

Are bank relationships, relationship marketing, and organizational learning important in explaining the performance of BPR?

Based on the general issue, five research questions will be answered through the field research:

1. **What are behavioral characteristics of BPRs as an intermediary function in reacting to constant changes to their business environment driven by external crises and financial market competition?**

BPR as a bank unit operates autonomously regardless of the ownership group. It does not only compete with other BPRs, but also commercial banks which can penetrate the BPR market but not vice versa (irreversible). The micro financial market is highly competitive, except for BPRs located in a remote area or in a sparsely populated area.

BPR is treated as having a strategic position because it is close to the clients. The closeness is not only geographically, but more than that it is tied to the business relationship. When BPR is able to maintain the relationship as a resource, it will not only increase the ability to compete, but it will also partially eliminate asymmetric information that can potentially increase credit allocation. In a competitive environment, players try to get good or valuable clients. There is a long term relationship risk here, that is, the degree of valuable client exit from a relationship. Each individual bank may react differently toward growing competition in the marketplace and occurrence of external crises.

2. **What are the behavioral characteristics of BPR's clients recipients of BPR services based`on different relationship dimensions and underlying changes of the business environmnet?**

Policymakers and regulatory institutions tend to maintain the assumption that low income society is credit hungry, especially small financial businesses. The government, through the Ministry of Finance, Ministry of SMEs and Cooperatives, regional governments, and some researchers or consultants believe that most of the approximate 40 million SMEs (2002 data) cannot acquire bank credit. They struggle to gain access to credit from a formal bank, since some inhibiting factors remain inherently unavoidable. These authority bodies create various policies which encourage banks to serve them, especially SMEs, which saved the country during the crisis period. The efforts are getting more massive and intensive with the emerge of micro

divisions in some commercial banks, which are various credit programs which have subsidized elements that go to the same segment that BPR serves**.**

In this situation, existing debtors and potential debtors should have more choices, as there is an increasing risk of a BPR client switching to a competing bank. BPRs have invested greatly in maintaining their bank-client relationships. The relationship investments begin from a credit investigation, monitoring, extending progressive lending, etc. within the credit cycle. Satisfied clients will remain loyal, thus increasing BPR's retention rate or lowering the exit rate of good clients. However, good clients who are satisfied with BPR services are wooed to switch to a competing bank. Through marketing campaigns, competing banks have more attractive offers, so that BPR clients may see these offers as having a higher perceived value or even real value. This way of reasoning will enrich the analysis in answering the research question.

3. How do the bank-client relationship, relationship marketing, and organization learning contribute to the performance of BPR?

As a relationship between a bank and its clients progresses, the bank accumulates more relevant information about its clients. This assumption is a foundation of the bank relationship theory, which provides a chance to get rid of the asymmetric information problem. A bank-client relationship can potentially create value for both a bank and its clients. Consequently, it will likely support sustainable performance for a bank and its clients. However, Ongena and Smith (1998:p.4) suggest it is better to understand the impact of a bank relationship on bank performance. Their review of the bank relationship focuses on commercial bank relationships with firms as customers. The study or the theory of organizational learning concurs that the duration of a relationship is important, but it cannot simply be assumed that the longer a relationship lasts, the more opportunities there are to transfer explicit and tacit knowledge or information from clients to the bank. More important is that the intensity of the relationship (frequency of face-to-face contact) where the process of improving actions, detecting and correcting error through better knowledge and understanding take place (see, Argyris, 1999). Thus, the duration of a relationship has more meaning to create value for the BPR whenever it is through organizational learning. A study about the duration analysis or event history of the development of a relationship between a bank and its clients is known as the life cycle of a relationship. The life cycle of a bank-client relationship starts from the first transaction and progresses through repeated transactions and at any point in time the relationship may breakup for whatever reason. The bank relationship theory says that switching from one bank to another is the behavior of clients from one bank to terminate a bank relationship driven by exogenous or endogenous factors (Ongena and Smith, 1998). They do not specify the dimensions of exogenous or endogenous factors, while the relationship marketing filed of study does specify.

The relationship marketing study answers why and how valuable clients can be maintained in a long term relationship. This study also specifies a list of possible driving force of client switching. Organizational learning facilitates in adapting to environmental changes by making behavioral changes that can lead to higher performance. Relationship marketing and organizational learning are sources of competitive strategy. By taking from the best aspects of each of the studies, a cross-fertilization model will enrich testable hypotheses in order to answer this research question.

4. What are the effects of the duration of a relationship, value of a relationship, client satisfaction, preventive measures, and competitor actions (luring) on client intention to leave?

Relationship marketing studies are rich in analyzing customer behavior. Client exit can be seen as positive or negative. Client exit due to a bank which is not able to provide service anymore, in order to comply with legal lending limits, is considered a success. This case is called client graduation. On another side, client exit to a competing bank is considered as a bank failure to maintain its valuable clients. The later be driven by internally triggered factor (e.g. client dissatisfaction) or by externally triggered factor (e.g. competitor promises). This situation is called client defection or desertion or drop-out. From a business point of view, both types of client exit are viewed as lost sales and should be prevented as much as possible.

The duration of a relationship can indeed create value for clients, and it can create client satisfaction that will ultimately subdue the desire to leave the relationship. However, competition can threaten this relationship. Competitors may encourage client exit by luring them with more profitable offers. Bank clients are lured by competing banks to attract clients who are actually loyal to an existing bank. Sooner or later these measures which create a perception that the perceived value of a relationship with a competing bank is better than the existing bank will push many clients to try it once. After that, clients may continue having repeat loans at the competing bank. A competing bank will try to successfully lure some of an incumbent bank's clients. Client desire to move to a competing bank can emerge at any time. Smart bank managers who are in a vigilant position can take some preventive measures to halt those clients, who have been in a relationship with the bank for a long period, from desiring to leave the relationship. This question is an inquiry to these interrelated factors to ensure future sustainability in a bank-client relationship through some testable hypotheses.

5. How does the relationship dimension in a business exchange as a complex process contribute to BPR performance?

Despite a large body of accumulated theoretical and empirical studies on bank relationships, there has been little academic attention in analyzing precisely how bank-firm relationships work (Berger and Udell, 2002). The finance literature puts more emphasis on quantitative aspects of the dimensions of the duration of a relationship, number of bank relationships, ownership and control through shareholding of firm borrowers. Hence, the process of bank relationships is seen as a black box. A relationship is an intangible resource which can be used to increase business performance. Even though a bank cannot have it privately, it is a resource in a network relationship.

Banks rely upon account officers, especially for credit. They are people who use their time on a daily basis to make business relationships with clients. The tacit information gathered from clients during monitoring is not easily transferred, to be processed and then retrieved by the bank manager to enrich and speed up future credit decision processes. It happens due to some obstacles: (a) the existence of tacit knowledge, (b) the variable speeds of organizational learning, (c) the underutilization of information communication technology (ICT), (d) the bank manager may not see the relationship as a strategic instrument, etc.

The duration of a relationship in bank relationship studies is viewed as an opportunity for banks to gather private and “soft” information from their clients through frequent and continuous (especially through face-to-face) communication to release asymmetric information problems. Organizational learning studies state that practically all institutions have organizational learning but only a few institutions have a clear direction to improve themselves through a learning process. This question aims to go in depth to discover whether a bank manager indeed makes use of the relationship resources from the processes of the bank-client relationship. Within the network or dyadic of relationship, the information transmission, processing, retrieval and making use of it as knowledge for the benefit of decision making is a complex matter. The case studies will be based on three frameworks of analysis: (1) the value chain of a social network and the personal relationships of many transactions, (2) principal-agency relationships, and (3) social and location-dependent relationships. Network relationships do not only happen outside the bank but also inside the bank. By adopting these frameworks, they allow researchers to know more about how the relationships among parties work. This in-depth study helps to understand this complex social and business relationship that enables the fifth research question to be answered.

At a glance, all questions mentioned above give an impression that concern is mostly given to SME lending through relationship business interactions. Back to basics, a bank, as an intermediary institution, has to consider loans and deposits in tandem. This study does not ignore the role of deposits, which is why this topic will be included as an addition to this study in answering these research questions. Small business lending and sources of funding are

interesting topics of discussion among policymakers, researchers, and microfinance institutions, which inherently carry some broader interesting issues than in this study. Short arguments following the five research questions are based on the theoretical and empirical reviews that are available in Chapter 2.

1.4. Scope of the Study

Ongena and Smith (1998) traced back studies on banking relationships, and they found that the early research into the value of a bank relationship started before the 1970s. They also stated there is a need to better understand the impact of bank relationships on bank performance (Ongena and Smith, 2000, p.24). According Ongena and Smith, there are at least six different strands/or motivations of research interest in the value of bank relationships. Three of them that are relevant to this study are as follows. First, there is worldwide concern on the value of bank relationships to small business finance since small firms typically have a higher barrier to gain access to formal financial intermediaries and public "arm's length" financing. They are vulnerable to an imperfect financial market characterized by information asymmetries, in which they are inherently informationally opaque entities (Berger, Klaper and Udell, 2001; Patti and Gobbi, 2001). The second research interest is in duration analysis (Bolton, 1989, Keifer, 1988, Ongena and Smith, 2001; Schreiner, 2001) and choice in the number of bank relationships (bank switching) and exclusive relationships (Foglia et al., 1998; Ongena et al., 1999; Detragiage et al., 2000; Farinha and Santos, 2002). The third research interest is an embryonic study on the importance of the organizational structure of relationships (Berger and Udell, 2002).
Relationship marketing puts an emphasis on the processes of relationships, but it has something in common with bank relationships, since both of them are concerned with how long-term relationships can benefit the bank, as the credit supplier, and its clients. The processes of relationship development specifically focus more on customer retention management in relationship marketing. According Grönroos (1994), the focus is shifting from the activity of attracting customer to activities which concern having customers and taking care of them. Moreover, Fornell and Wernerfelt (1987) argue that most successful business firms employ offensive as well as defensive marketing strategies. The objective of the offense is to generate new customers; the objective of the defense is to keep current customers. Defensive marketing become essential whenever the cost of generating a new customer is high relative to the cost of retaining a current customer. A fundamental objective of defensive marketing is to manage customer dissatisfaction in such a manner that its negative and harmful effect on the firm are minimized. The basic premise of relationship marketing is that cost of retaining an existing customer is less than cost of acquiring new customers (see e.g., Bolton, 1998). The higher level of customer satisfaction lead to greater customer loyalty (Anderson et al., 1997; Anderson and

Sullivan, 1993; Bearden and Teel, 1983). More satisfied customers will return (with their friends) and buy again in the future. It means customer satisfaction can increase **retention.** Customer satisfaction measures therefore hypothesized to be indicators of future revenue, and perhaps future profits (Rust and Zahorik, 1993). The defensive marketing may be considered as variant of relationship marketing. Therefore, underlying assumption of how to prevent the most valuable customers from switching to a competing bank, or relationship termination, is believed that it is financially more lucrative to retain existing clients than to attract new clients

While the organizational learning study states that the duration of a relationship cannot be explained by the information transfer except it is obligatory to see the processes (speed and intensity) of improving actions through better knowledge and understanding, a process of detecting and correcting error.

In general, many empirical studies focus on the impact of relationship marketing on business performance in terms of e.g. profit, revenue, or other measures (Gröroos, 1994; Payne et al., 2000; Ralston and Wright, 2003; Reinartz and Kumar, 2003; Sin et al., 2002), and also the impact of organizational learning studies on performance (Cavalery, 2004;Fiol and Lyles, 1985; Lei et al., 1999; Sadler-Smith et al., 2001;; etc.).

The existing separate studies examined the impact of bank relationship (Ongena and Smith, 1998), relationship marketing (e.g., Payne, 2000), and organizational leaning (e.g., Sadler-Smith, 2001) on firm performance. There is a void of studies on integrating bank-client relationship, relationship marketing, and organizational learning in explaining firm performance, especially bank (BPR) performance. This study addresses this gap using empirical research through a cross-fertilization of these three concepts. In order to answer the last three research questions, the main concepts above will be translated into two models: (a) the bank performance model and (b) the client intention to leave model. Since relationship dynamics is a complex process, one chapter will focus on covering this matter to get inside the black box of relationships. Therefore, in addition to Chapter 1, there are nine other chapters reflecting the scope of the study as following.

In Chapter 2, a discussion is devoted to reviewing the theoretical and empirical evidence of the main concepts (constructs). This chapter is a supporting structure to elaborate relevant dimensions of concepts in the five research questions. In other words, the review will generate a list of measurable variables (or manifest of observed variables) to measure five unobserved concepts, or their sub concepts. The Islamic (sharia) bank is discussed as a special case in relation to a revival in Islamic spirit in a country with a predominantly Moslem population like Indonesia. As closure of this chapter, the last section presents a synthetic model and some statements of testable hypotheses as stepping stones in the research.

Chapter 3 highlights the existence of microfinance institutions in Indonesia, covering the most recent relevant aspects of MFIs, to depict a big picture of BPRs, ranging from geographic distribution, degree of capital resistance amid the financial crises, intermediary function, and business climate. Co-existence of subsidized and commercial loan, dual banking system, and the challenge of licensed BPRs in Central java are being part of Chapter 3.

In Chapter 4, the research methods discuss the relevant characteristics of BPRs in the location of the study, Central Java, based on most recent available data and will be updated upon receiving new information from multiple sources. Based on Chapter 3, two list of measurement models are presented in Chapter 4 along with a discussion of methodological issues such as the level of measurement, unit of analysis, field survey and in-depth study, and statistical analysis. However, it is important to note that an additional list of observed variables which are translated into research questionnaires. They act as supporting data collection for an exploratory (descriptive) analysis presented in Chapter 5 and Chapter 6.

Chapter 5 and Chapter 6 address research questions one and two concerning an exploratory analysis of BPR and its clients respectively. These two chapters are a complementary analysis to Chapter 7 and Chapter 8.

Chapter 7 and Chapter 8 are explanatory studies based on the hypothesized models developed in Chapter 2, which are derived from research questions three and four. Essentially, this research expects to find the gist of cross-fertilization to get the most valuable results. However, it always danger of misspecification in modelling, regardless of the underlying theoretical and empirical evidence are quite enough. Chapter 9 is expected to shed light on questions that may arise in the explanatory analyses of Chapters 7 and 8.

Chapter 9 discusses the case study derived from research question five. As mentioned above, this chapter will be based on three frameworks of analysis: (1) value chain of a social network and personal relationships of many transactions, (2) principal-agency relationships, and (3) social and location-dependent relationships. By adopting these frameworks, they allow researchers to know more about how the relationships among parties work.

Ultimately, Chapter 10 is the culmination of the study to extract all findings from the previous chapters. This chapter covers conclusions and their implications in bank-client relationships at a micro level and macro level. Last but not least, this chapter also expresses some possible limitations and further research issues.

To see an overall picture of the study, all ten chapters can be expressed in an interlocking diagram of the chapter structures (Figure 1-1).

Figure 1-1: The Chapter Structure Depicting the Interrelated Chapters