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The Need for Agile Relationship Lending between Small Business and Banks, towards a More Engaged Relationship: A Case Study in Khayelitsha, South Africa

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Abstract

Despite much attention being focused on financing small, medium and micro enterprises (SMMEs), they (SMMEs) continue to face survival and growth challenges. Banks tend to be reluctant to offer loans and financial assistance if, based on their assessment of financial statements, the small businesses do not have the ability to repay loans, caused by the level of "opaqueness" of information that the banks have about small businesses, which has resulted in the introduction of the concept of 'relationship lending.' If banks are more agile and have an engaging relationship with small businesses, they will be in a better position to use their discretion when granting finance. Through engaged relationships with small business, banks would better manage information asymmetry and offer some possible specialised support to SMEs. By using a semi-structured questionnaire, the study probed problems with information asymmetry between the bank and small businesses, towards more agile solutions and engaged relationships. A case-study based research was conducted in two established businesses in the informal township of Khayelitsha in the Western Cape of South Africa. It became apparent that transactional lending is not viable in a country where a large population lives in poverty. It is recommended that banks in developing countries such as South Africa be more agile in order to speed up access to finance by small businesses.

Keywords: SMEs, Funding, Loans, Asymmetric information, Banks, Relationship lending.
JEL Classification: G21.

Contribution of this paper to the literature
This study contributes to the existing literature by probing the problems with information asymmetry between the bank and small businesses, towards a more agile solutions and engaged relationships.

1. Introduction

Globally, it has become a known phenomenon that development of Small, Medium and Micro-Enterprises (hereinafter referred to as "SMMEs") can significantly contribute to GDP, reduce unemployment and promote social welfare (Ladzani and Van, 2002). In South Africa, "research shows that while 98.5% of the country's economy is made up of SMEs, they are only delivering 28% of all jobs" (Writer, 2018). The Small Business Institute (2018) warns that the National Development Plan's goal for small business to create 90% of the jobs by 2030 will be stillborn, unless this vital segment of our economy is properly understood.

South Africa, like many other countries, has identified developing small businesses as one of the significant solutions to developmental issues (Herrington *et al.*, 2009). However, the 75% failure rate is alarming and one of the highest in the world (Olawale and Garwe, 2010). South Africa has many enabling factors for business development, but smaller businesses do not prosper, as intended. The President of South Africa Mr Cyril Ramaphosa (The Presidency, 2019) has asserted that, "the growth of our economy will be sustained by small businesses, as in the case of many countries". The researcher is of the view that given the existence of the right conditions (milieu), a well-articulated SME community has the capacity to, and dynamic transformational power in stimulating socio economic growth.

One of the most cited obstacles to SMME sustenance and growth, is access to finance (Olawale and Garwe, 2010). Other factors include market access and lack of management and skills (Ministry of Trade and Industry, 1994). Financial institutions have traditionally been risk averse to offering finance and other services to the often fragmented, risky and geographically micro and small businesses (MTI, 1994). The World Economic Report (Schwab, 2017) released the statistics Figure 1, about obstacles that are faced by businesses in South Africa and access to finance is cited as the 10th out of 16 factors that are problematic to businesses in South Africa. This report is based on all businesses, not only to small businesses; to small businesses perhaps; access to finance would be further up than 10th.

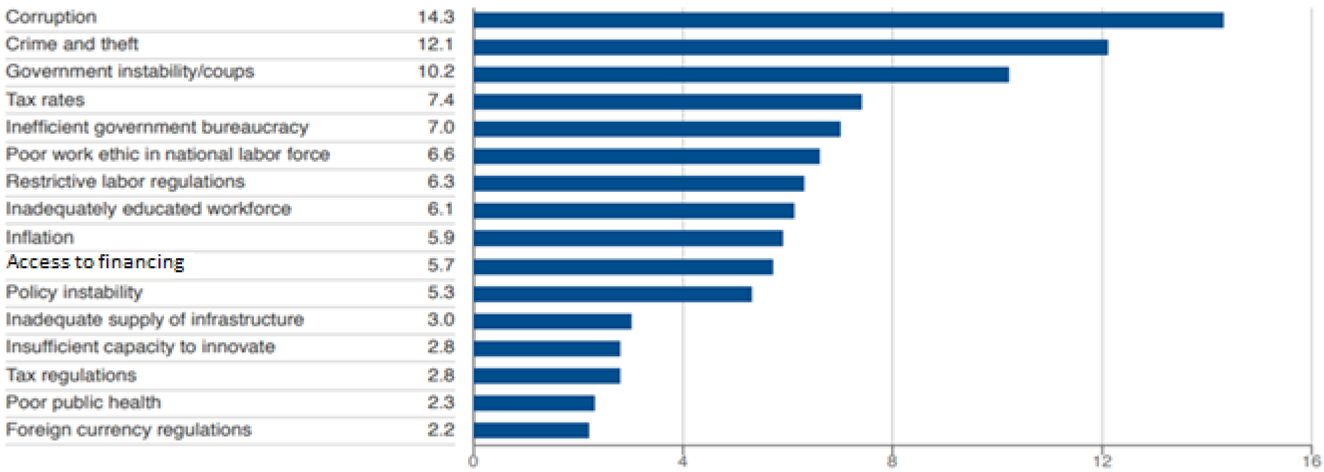

Figure-1. Most problematic factors for doing business in South Africa.

Source: Schwab (2017).

It is against the above background that this paper explores the extent of the relationship between banks and SMEs and to determine if the relationship is a determinant of granting loans. It uses qualitative interviews and attempts to discover what relationships exist between the Small businesses and banks, in Khayelitsha, Cape Town, South Africa.

2. Literature Review

Berger and Udell (1998) draw attention to four main lending methods, namely, financial statement lending, asset-based lending, credit scoring lending and relationship lending. The first three are based on "hard" information and the last one places great emphasis on "soft information" on a relationship established by a bank with the SME. Financial statement lending refers to lending based on information extracted from financial statements, and asset-based lending emphasises the collateral made available by the firm, whereas credit scoring uses statistical modelling and more so includes the financial state and history of the business owner. Relationship lending is lending that is based on proprietary information about the business and its owner, over time, which "soft" information can be gathered through interaction with the community for example, the customers' and suppliers' knowledge of the owner, business and its environment. This information may be more important to financial statements, collateral and credit scores.

Post 1994, South Africa was challenge to address the triple challenges of poverty, unemployment and inequality, and SMMEs presented the potential to contribute to addressing the aforementioned challenges thorough contributing to economic growth and international competitiveness. It has been documented that South Africa's SMMEs contribute 56% of private sector employment (Ntsika, 2002) and 27-34% of the GDP in 2006 (Department of Trade and Industry, 2008). According to Ladzani and Van (2002) in South Africa, SMMEs have been highlighted for employing approximately 17% (2.4 million) of the total of 14.3 million economically-active population. This employment has, however, been negated by the persistent unemployment rate which in 2013 was 25.2% (Statistics South Africa (SSA), 2013). Economic growth has increased in recent years, however it has not proved sufficient to significantly curb unemployment. Employment growth is also negatively affected by; skills shortage, limited entrepreneurial capacity (DTI, 2008). Table 1 reflects that between 2004 and 2007, the SMME sector grew by 27% in terms of the total number of formal enterprises (DTI, 2008). There was however a decline in terms of micro enterprises (5.6%), which contributed to a resultant shrinking in the total number of formal registered businesses, from 50% in 2004 to 37% in 2007.

Table-1. Stats SA enterprise figures by category, 2004 and 2007.

Enterprise category	Integrated business register 2004		Integrated business register 2007		Percent growth 2004 - 2007
	Count	Percent	Count	Percent	
Micro	212161	50.3%	200377	37.4%	-5.6%
Very small	170338	40.4%	251920	47.0%	47.9%
Small	32397	7.7%	63193	11.8%	95.1%
Medium	6748	1.6%	20750	3.9%	207.5%
Total SMME	421644	100.0%	536240	100.0%	27.2%
Large	4596	--	17251	--	275.3%
All enterprises	426240	--	553491	--	29.9%

Source: SSA (2013).

2.1. Definition of Small Businesses

Definitions of SMMEs are difficult to comprehend as the labour, turnover and capital intensities vary significantly. The National Small Business Act of 1996 defines a 'small business' as follows:

> *"… a separate and distinct business entity, including co-operative enterprises and non-governmental organisations, managed by one owner or more which, including its branches or subsidiaries, if any, is predominantly carried on in any sector or sub sector of the economy mentioned in column I of the Schedule."*

Informal small businesses in South Africa are unregistered, typically operated from home, the street or at taxi ranks. They typically source finance via small unsecured, short-term personal loans, form households and individuals, or corporate social investment funds from large corporates. If these informal businesses become successful, they may graduate to become formal businesses whose need for financing becomes even greater. However, at this stage they do not necessarily meet any banks' credit policy or lending criteria, which may prevent it from growing and subsequently creating employment.

2.2. SMME Development

In order to support SMME development, the 1995 South African White Paper on SMME development proposed an Integrated Small Business Development Strategy for 2005 to 2014, which strategy is based on three pillars, namely:

- Increasing the supply of financial and non-financial support.
- Creating demand for SMME products/services.
- Reducing regulatory constraints.

The Integrated Small Business Development Strategy (DTI, 2005) identifies the following institutions as important implementation agencies for the strategy. These agencies include both SMME-solely-dedicated support agencies and institutions with broader functions: Small Enterprise Development Agency (SEDA), South African Micro-Finance Apex Fund (SAMAF), Khula Enterprise Finance Limited (Khula) and the National Youth Development Agency (NYDA).

2.3. Commercial Banks

South African financial services to small business enterprises are predominantly provided by commercial banks, these include the four major banks, being First National Bank, Nedbank, Amalgamated Bank of South Africa (Absa) and Standard Bank. These banks are known to do mainstream and business banking and not so much development finance. They have divisions intended to provide finance to businesses based on traditional financing methodologies and systems which are akin to financial statement lending. These banks use debt-financing that requires collateral or a guarantee with an asset value. Hisrich and Peters (1998) suggests that collateral can be in the form of personal assets such as land, house, car or stock and/or business assets, such as land, building or equipment. However, although there are a number of products offered by commercial banks to assist small businesses, including, loan products, asset finance and equity funds, such offerings are primarily subject to the provision of collateral and financial statement analysis, providing collateral is very onerous for small businesses.

Collateral in credit risk is one of many major discussion points and debate in credit provision. Banks lend money to borrowers, on condition that the amount of finance, is to be repaid according to terms agreed upon at the inception of the loan. In order to mitigate their risk of loss due to the borrower not servicing and repaying the loan, the bank orders collateral as a condition of granting the loan. This collateral may serve to minimise a loss that might arise due to adverse lending decisions, especially in relationship lending (Stiglitz and Weiss, 1981).

2.4. Relationship Lending

The banks' risk appetite may be influenced by inter-alia, how long the bank has known the borrower and how much the bank knows about the borrower. Because of an existing relationship, a bank may find it easier to overcome the information asymmetry problem, by being able to gather financial and non-financial information from interactions with the borrower. There is conflicting literature on the scale of interest rates linked to the different stages of the bank-borrower relationship. For example, Boot and Thakor (1994) find that loan rates decline as a relationship matures. Existing evidence from the United States suggests that small businesses that forge bank relationships experience less credit rationing and are more likely to be given access to finance (Cole, 1998). Evidence from the European continent suggests that relationship lending may not be entirely beneficial for the borrower (Mayer, 1994). Elsas (2005) however, argues that relationship lending does not become successful simply by the duration of the borrowers' relationship with the bank, but rather on the status of the lender.

Small businesses normally deal with a specific person known as a "relationship manager", "consultant" or "banker". Should bankers lose interest in servicing small businesses, then small businesses are lost to smaller financial institutions (such as community banks) that use "soft" information to a greater extent than larger, commercial banks. Complex hierarchies of larger banks, therefore, become an impediment to relationship lending and present relationship lending as being more of a challenge to larger banks than smaller ones (Stein, 2002). Cole *et al.* (2004) believe that the biggest difference in the loan offering process between small and large banks is the weight they attach to the quantitative and discretionary information. Small banks attach more weight to discretionary ("soft") information whereas larger banks attach more weight to the quantitative financial information.

Relationship lending poses some great possibilities for the SMME fraternity, however, evidence needs to be gathered as to whether it is plausible in terms of managing long term risk for banks. It is evident from the above discussion that a number of factors influence the relationship lending success. The duration of the relationship, the scope of the relationship, collateral and the relationship manager are factors that make or break the success of relationship lending.

3. Research Design and Methods

In order to achieve the research objectives, a case study approach was adopted, by focusing on two established small business enterprises based in Khayelitsha Township, Cape Town, South Africa. These two enterprises were chosen because of close proximity to the researcher. The aim of the study was to demonstrate that relationship lending could serve as a solution to the credit accessibility problem faced by SMMEs in South Africa.

The primary data was collected through interviews using semi-structured questionnaires comprising open- and close-ended questions. Interviews seemed to be a viable research tool to gain insight into the experiences of the research participants with banks. The data gathered through the interviews was categorized into the following relationship lending themes:

- Challenges encountered upon start-up.
- Reasons for declined finance.
- Service perceptions of banks.
- Duration of bank-borrower relationships.
- Scope of relationships.
- Role of collateral.
- Relationship manager.
- Other relationships.

3.1. Research Findings

Entity A was a restaurant that hosts corporates events, owned by a 53 year-old woman (with 40% share in the business) and her business partner, who is her 26 year-old daughter owns the majority (60%) of the business. The business has been in operation since 2010.

Entity B which is an entertainment business that provides weekend entertainment to the elite and mature sector of the community was also owned by a woman aged 50 years, and she was the sole owner. The entity was registered as a Close Corporation since 2004. Prior to formal registration, the business was operating informally while the business owner was still in formal employment.

3.2. Source of Start-Up Finance

Entity A was established through the savings and pension funds of the owner. Credit funding was applied for from a bank credit, but the application was declined based on the adverse credit record of the borrower.

Entity B was also funded from the owners own funds, being the proceeds of her retirement. The owner also applied for finance at a bank but the loan was declined. Nevertheless, she made progress using her own resources, but when she was becoming successful, the bank showed interest in her business, but because of her poor experiences with the bank, she refused to get involved with the bank. Instead she used a R1.2 million loan from Khula Finance.

3.3. Challenges Encountered at Start-Up

i. Access to Finance

Both entities alluded to two great needs: assistance at the time of start-up and the bridging working capital finance. Both businesses, they struggled to get financing when at the start-up phase.

Upon start-up, the owner of Entity A realised that corporates wanted her service, but after sending an invoice she would have to wait for a month or two, before receiving payment. Because of insufficient working capital, at times she would owe her creditors for long periods, and thereby earn a bad credit record. She believed that, had she received financial support, she would have performed better than she has done to date.

After running her business for a while, the owner of Entity B discovered that as her business grew she could not keep up with the demand and had to source funds in order to increase her stock. This proved to be a very difficult exercise, but she overcame the hurdle since she also obtained finance from Khula Finance.

Other than Access to finance, both entities mentioned the following challenges upon start-up:

ii. Formal registration hurdles

Both entities did not have knowledge of registration places, guidelines and processes. The information they gathered was from informal sources and not always reliable.

iii. Information and 'Know-how'

Information regarding suppliers and network of businesses was not easy to find. Though they could find some information, the suppliers were not always the most competitive in terms of price and supply terms.

iv. Skills

The two business owners started businesses that on which they did not have in-depth knowledge and, as such, had to learn their industry-related skills by doing. Both pride themselves in the fact they learnt very quickly, they understood budgeting and their financial requirements. However, they conceded that their formal accounting skills are minimal as they rely much on their accountants who prepare their financial statements.

3.4. Reasons why Applications for Finance were Declined

Entity A's application for credit was declined because of adverse credit scores relating to the owner and she was not willing to provide her unencumbered residential property as a collateral. The adverse credit scores were instrumental in motivating the owner of Entity A to start the business – she wanted to get out of the debt trap and wanted to liberate herself financially.

Entity B's application for finance was declined because the bank did not believe that the business was viable. This was disappointing to the owner; however, more disappointing was that she felt the bank understood little of the potential of the business.

3.5. Collateral as Part of the Loan Contract

Due to a bad credit record at the time of applying for the loan, the bank requested collateral from entity A. However, the owner she was very unwilling to do so. Entity B had a loan which was backed up by the property collateral. The owner had a number of loans, but they were not business loans, but personal loans taken when she realised that her working capital was not sufficient.

3.6. Perceptions of the Banks

The initial perception of the banks by both entity owners, was that the banks did not want to assist small businesses, as both credit applications were declined. However, only once the businesses were up and running, did the banks show interest in them. Hence, the owners had a perception that the banks only want to assist existing and successful businesses, and not start-up businesses.

The owners of both entities commented that the banks did not attempt to understand their business, they believed that, had the banks understood their businesses and opportunities, they would have offered them finance. Thus, a relationship would have allowed the banks to have proprietary knowledge of the businesses.

3.7. Duration of Relationships

Since start-up in 2010, Entity A has been banking with the same bank, but the same bank declined the application for a start-up loan. The owner indicated that the bank had been generating revenue from the business, yet the support was minimal.

Entity B's experience is different since the owner maintained accounts with three banks since inception in 2004. She also changed banks as soon as she had bad service experiences. She also indicated that all the banks have only been interested in account and were generating revenue from the many products she had procured with them. In her view, the banks did not have the "appetite" to grow start-ups.

3.8. Scope of Bank-Small Business Relationships

The business entities have concurred that the banks do not have solid relationships with them. The banks did not readily visit the businesses to understand their business or obtain first-hand information on the success of their businesses. Thus, the banks were unable to assist the clients who required credit because they lacked knowledge on the businesses.

3.9. Relationship Manager

The owners of both entities responded positively to having a community-based bank and the reason cited for this, was personal access. The entities believed that the relationship manager is the best person to understand their business at grassroots level. They believed that the relationship manager is the person that should be visiting them and gathering information about their business and will be able to assist should they apply for funding.

The business owners assert that the relationship mangers focused more on the financial statements than on wanting to understand their businesses. The business owners complained that they seldom see their relationship managers. More so, both the owners agreed that they struggled with having to deal with different relationship managers consistently, since that have had to explain their business needs repeatedly to the different relationship managers. This, they believed is a value destroyer and they hoped that there could be some stability in terms of having only one relationship manager.

3.10. Other Important Relationships

These business owners had networks who were well known in the community and industry and belonged to inter-alia, Khayelitsha Business Forum, Cape Town Tourism, the Foundation for African Business and Consumer Services (FABCOS), etc. These organisations added value in terms of knowledge and the direction of various projects in the respective community.

From the documented experiences of these two businesses, it would appear that the information asymmetry problem remained a crucial point. The bank, at a high level, seems interested in assisting small businesses; however it does not attempt to obtain first-hand of the business operations. It would appear that the banks lean more towards traditional transactional lending. The relationship lending phenomenon appeals as a great alternative to source the "missing" information about the company. Since the businesses are fully operational, it would seem that they are being effectively managed. Hence, there seems to be an opportunity for the banks to assist with financial support to help grow these businesses.

4. Conclusion

From the findings it is clear that the core to growth and development of small business, is access to finance. Whilst banks are somewhat unwilling to provide finance, they are not able to gather information about the businesses. Businesses that are not astute in terms of financial statement preparations struggle to convey their business performance to the banks that use transactional lending. This leads to an information asymmetry problem, which relationship lending theory proposes as a solution to this problem.

4.1. Recommendations

The business owners in this study had very limited business information when they started their businesses. Thus, provision of mainstream business information concerning the SMME environment, such as business registration processes, could be worthwhile to both the bank and their clients. By understanding the businesses which have accounts with them, banks will be better positioned to assess the businesses ability to meet is credit payment obligations. Banks could further invest in a new credit scoring model that will somewhat quantify relationship information. Such information could include the reputation of the client's suppliers, landlords and the community. For example, the businesses' ability to meet their obligations may be assessed by looking at the payment records from suppliers. Viability of the business may also be assessed by interviewing the businesses' clients.

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