Study on Application of Relationship Lending in SME Financing

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Abstract: The small-and-medium sized enterprises are the impetus of regional economic development. However, due to the financing difficulties, they often encounter great barriers. Information asymmetry between banks and enterprises is the essential reason for it. In addition, the SMEs can not provide eligible securities, and this worsens the financing condition of the SMEs. Research shows that relationship lending will solve the problems of information asymmetry and bring in more loans to the SMEs. Relationship lending is quite practicable in domestic market, so we should take active measures to promote the development of relationship lending in China.

Keywords: Relationship Lending, Small-and-medium Sized Enterprises, Financing

1 Introduction

China is now developing private economy energetically, hoping to promote the development of nation's economy and improve the market-oriented system. However, it has become a common phenomenon that private economy, especially the SMEs is facing serious financing bottlenecks. Now the direct financing market in China has not been fully developed, this can be proved by the following aspects: First, Chinese government is the main part in the bond market and the mobility of the bond product is relatively low; Second, the stock market has basically become the financing channel of large enterprises and the efficient financing function of the growth enterprise market is still expected by the public; Third, as the accumulation of system problems, there exist a higher transaction costs in indirect financing market; Finally, under the restraints of their own risks, banks stint to loan and this hinders the development of enterprises. Relationship lending will to some extent ease the financing problems of SMEs in China and the study of relationship type loan has practical significance.

2 The Analysis on the Financing Problems of SMEs

2.1 Information asymmetries

Information asymmetry is one of the main reasons of SME financing. Judging from China's present situation, the asymmetric information problem is more serious than developed countries. In most of SMEs in China, there exist financial system distemperedness problems, which make the SMEs quite difficult to provide proof of their level of credit information in looking for loans from financial institutions. As the information in the SMEs is internal, it is hard for bank to get information for the SMEs through normal channels. Under such circumstances, banks could either give up lending to the SMEs in order to avoid information adverse selection caused by asymmetric problems, or increase investment in human and material resources to improve information collection and analysis. Besides, most of the SMEs lack of collateral assets, so for the consideration of balance of risks and benefits, commercial banks tend to focus on reliable customers instead of lending to the SMEs.

2.2 Higher rate of bankruptcy and breaching of faith in the SMEs

The primary objectives of commercial banks are safety, liquidity and profitability. However, the high rate of closure and breaching of faith in the SMEs make the banks difficult to follow the safety and profitability principles. The SMEs are mostly labor-intensive enterprises, they have small asset scale, weak strength, so the operational risks are relatively high and the possibility and frequency of bankruptcy are even higher facing the intense market competition. According to a statistics, nearly 30%
private SMEs in China will disappear within two years and nearly 60% of the enterprises will disappear in 4-5 years. In addition, SME operators generally have a weak concept of credit, owning interests, escaping debts and bilks often occurs, which cause the credit delinquents of the overall SMEs and the high costs in financing. Due to this high rate of bankruptcy and breaching of faith, banks are not willing to lend to the SMEs.

2.3 **Lack of financial institutions with professional services for the SMEs**

Although China has established diversified financial system mainly based on market, the state-owned commercial banks still in the monopoly position. The joint-stock banks and several local financial institutions are numbers-limited and they did not make full use of their own advantages to develop accurate and reasonable market positioning strategy, which resulted in a lack of regional and local financial institutions compatible to large state-owned bank in financial system. The SMEs can hardly be conducive to financial support. According to the data provided by our scholars, in the main sources of funds for the SMEs, the non-regular financing is as high as 65.2%, while external sources of financing loans such as loans from banks and credit cooperatives accounted for only 10.7%. The emergence of the irregular financing channel although ease the pressure on financial needs of the SMEs, on the other hand, it also caused confusion in financial markets, which is not conducive to the development of the entire financial market.

From the above analysis, we suppose the financing problems of the SMEs can not be fundamentally solved through the guidance to commercial banks by fiscal and financial policies and other interventions as well as the external reform of commercial banks. Instead we should start to solve the problems from the information aspect. We may discuss about how to use the information superiority of banking intermediaries and to establish an effective long-term relationship between banks and the SMEs (i.e. relationship lending) to resolve the indirect financing issues of the SMEs under the premise of information asymmetry.

3 **The Roles of Relationship Lending in SME Financing**

As information opacity is the root reason of SME financing problem, the majority of the SMEs must solve the tough constraints of collateral issues and to provide qualified information, which will prevent the result of adverse selection and moral hazard caused by information asymmetry. Relationship lending just involves in such soft information that is difficult to quantify and transmit. The so-called "relationship-based lending" refers to the decision-making of the loans based on large number of relevant information obtained by long-term multi-channel exchanges between banks and business customers. Its precondition is the long-term, close or relatively closed financial relations between banks and borrowing enterprises. The characteristics of relationship lending are the flexibility of contracts and monitoring of banks, and it is a long-term cooperative acts between banks and enterprises. The relationship lending plays important roles in SME financing.

3.1 **Helping to ease the market failure in borrowing and lending market**

One of the fundamental reasons for China's SME financing difficulty is the market failure in financial transactions caused by asymmetric information between banks and enterprises. The asymmetric costs and benefits make banks refuse to finance commercially viable investment projects, and because of the lack of management capacity and the credit issues, the SMEs can not correctly grasp the opportunities to obtain finance. The relationship lending characterized by quasi-market trading is a common system arrangement built by banks and enterprises in order to overcome such market failures. Relationship lending can partially offset the credit gap generated by the SMEs' inability to provide qualified financial information and collateral, and it also can to a great extent replace so-called “hardware” such as financial data through soft information produced by the long-term relationship. Therefore, relationship lending does help ease the credit market failures in the credit loan market.
3.2 Helping to improve the loan conditions of the SMEs

By lending relationship, a long-term trading relation has formed between banks and enterprises. The large number of foreign empirical study shows that long-term transactions relations help banks to reduce lending rates to the SMEs, decrease guarantee and collateral requirements in loan, lower dependence on commercial credit and reduce the impact to SME loans caused by interest rate fluctuations. The study also found that the duration of lending relationship between bank and enterprise can be a positive correlation with the variable of corporate loans availability, and a negative correlation with the bank's collateral requirements. The number of banks that lease loans for businesses can be a negative correlation with the loading availability, and a positive correlation with collateral requirements; on financing costs, the loan interest rates with relationship of mutual trust can be lower than the rate without the relationship. The research literatures in many other countries show that long-term and transaction-partners focused relationship lending can improve the availability conditions of loans and can be more effective in alleviating the difficulties of SME financing.

4 Feasibility Analyses on Developing Relationship Lending in China

4.1 Social basis in developing relationship lending

China is a typical society that lays stress on social relations, so it provides a good social background for developing relationship lending. In the daily communication, it is easy to form to a huge network of relatives, friends and colleagues. All the people in the network follow the mutual trust and cooperation latent rules, which will create a strong binding force within the network. As a result of this network of relationships, the relatives and friends of the bank staff' work in the enterprises, and even he or she takes part-time job within the enterprises, so they may be quite familiar with every enterprise. They can realize the situation and degree of desires for loans of the enterprise through social networking. Good social relations in bank and its staff can generate enough soft information to reduce the cost of its decision-making and give an effective solution to adverse selection and moral hazard problems caused by the information asymmetry. This kind of relationship network in China makes up for the lack of credit, and is also the basis of relationship lending between banks and enterprises.

4.2 Favorable conditions to develop relationship lending

First, nongovernmental financing develops rapidly in China and has got an embryonic form of relationship lending. In practice, the patterns of nongovernmental financing are diversified. We just take Wenzhou-style fund-raising method as example, the people in Wenzhou will firstly go to the Chamber of Commerce or underground banks to finance instead of banks if they have good projects. It is an embryo of relationship financing between the SMEs and the so-called underground banks. Underground banks are mostly concentrated in rural locations, with strong local relationships, generally lending money to local enterprises. The dependence on the network of the personal credit and personal relations makes them be familiar with the operations and background information of the SMEs. Because this kind of loans does not require hypothecate and guaranty, it facilities the financing for the SMEs. Obviously, there is vitality in relationship lending.

Second, the establishment of private small and medium-sized banks has provided a good systematic background for the development of relationship lending in China. In order to solve the financing problems of the SMEs from the system level, China has established a number of private small and medium banks. For the system and scale reasons, these banks will take a different operational modals and business characteristics from state-owned banks for its survival. Relationship lending is the main direction of the development of small and medium-sized private banks. As for regional and community-based nature of small and medium-sized banks, they can get non-public information by keeping in close contact with SMEs in a long term, and they have advantages to release relationship loans to SMEs with opaque information. In addition, the organizational structure of small banks is relatively simple, the costs of transmission and processing soft information are quite low and they can
make decisions rapidly. Compared to the complex hierarchical structure of large banks, the development of relationship lending in small banks has more advantages. Third, the current financial and economic environment in China is conducive to the development of relationship lending. In theory, when the capital market is in a poor mobility and lack of protection to investors in legal systems, and when the SMEs play an important role in the economy, the government is in the financial constraint environment implementation, the relationship financing is easy to grow. AOKI Masahiko (2001) finds that if financial markets can not fully provide the sufficient project information in the form of opening information, at that time, it is of great significance for relationship lending to get business proprietary information through maintaining long-term relationship with business. In China, we are now in this period.

5 The Recommendations to Develop Relationship Lending in China

5.1 Reforming and developing existing small and medium-sized financial institutions
The existing small and medium-sized financial institutions should look squarely at its current difficulties, and pay equal attention to the reform and development. First of all, small and medium-sized financial institutions should recognize their own competitive advantages in the SME loan market and reasonably position the business focus; Second, the small and medium-sized financial institutions should improve the corporate governance structure, deepen the internal reform, change their operational mechanism, and to establish a sound internal control system to meet the requirements of modern enterprise system; Finally, the small and medium-sized financial institutions could enhance capital strength by introducing private and foreign capital, they should also speed up the disposal of non-performing assets so as to enhance comprehensive competitiveness and risk-resistance capability.

5.2 Establishing new private financial institutions to enhance competitiveness of SME loan market
The establishment of private financial institutions is good for the SMEs to introduce competition mechanism into financing and can also promote the conversion of existing financial institutions operating mechanism. We hope the small and medium financial institutions system, mainly based on private financial institutions, which to be built up in future, will eventually solve SME financing problems. The emergence and development of private financial institutions is the natural evolution result of market choice. The private financial institutions should follow in order and advance step by step to get access to the loan market.

5.3 Building up intermediary institutions and credit environment
The Government should provide support to improve intermediary services and SME guarantee system. It should encourage the establishment of a multi-form and multi-level loan guarantee corporation, in particular, intermediary agencies for social credit assessment survey. The government should also allow these institutions to provide SME credit results to relevant users for charge on the basis of independent legal person status. We should try to reduce property assessment procedures, decrease the charging standard of loan guarantee and property assessment, standardize collateral management, speed up the construction of social credit system, foster sound social credit consciousness and create better environment for SME financing.

5.4 Strengthening supervision and support to small and medium-sized financial institutions and preventing financial risks
The government should provide supports to financing behavior between small and medium-sized financial institutions and the SMEs and lead them to concern about long-term interests. It is also necessary for the government foster industry development, maintain and manage credit order, that is, crack down on false credit and punish fraudulent action. The enterprises and intermediary institutions that distort credit information must be punished according to relevant laws to create a good environment.
for relationship lending in China.

6 Conclusion

Relationship lending is the natural choice of small and medium-sized financial institutions to develop their own advantages in the market competition. The development of relationship borrowing and lending operations depends on the establishment of a vibrant, market-oriented small and medium-sized financial institution system. We should take active measures to further develop and improve small and medium-sized financial institutions system in China.

References