The Relationship Between U.K. Banks and Their Small Business Customers

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ABSTRACT. Much emphasis is placed upon the benefits to both parties of a 'good' relationship between banks and their small business customers. Having explained the significance of SMEs in the U.K. Economy, the papers goes on to consider, briefly, some of the arguments which underpin the rationale for these relationships. The roles of information and communication are discussed and the poor co-ordination between banks, SMEs and their accountants is highlighted. Evidence from over 6,000 small businesses in response to the Forum of Private Business survey in 1994 is then presented. This demonstrates the strong positive association between more participative relationships and more positive perceptions of their banks by firms. Finally it is suggested that a virtuous circle of information and communication could be established if the parties cooperate in a systematic process of risk assessment.

1. Introduction

The economic contribution of SMEs to sustained economic recovery and growth will become more rather than less important over the next decade. It is vital that this contribution is not constrained due to imperfections in the provision of factor inputs such as management and labour skills, finance, premises, etc. This paper focuses upon the provision of finance to SMEs and the potential for improvements in this process. After a brief indication of the significance of SMEs in the U.K., the paper proceeds to consider sources of constraints and in particular the causes of shortfalls in financial provision. The role of information and communication between firms and providers of finance is identified as a key issue. The paper closes by illustrating how a virtuous circle of information and communication can be achieved in order continually to improve provision of finance to SMEs.

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2. The significance of SMEs in the U.K. economy

Small firms constitute a very large proportion of all businesses in the U.K. Consistent with the picture in most developed economies, around 93% of firms have a turnover of less than £1m. Although employment creation data are notoriously difficult to interpret, it is now generally accepted that SMEs will be net job creators whilst large firms will contribute little to net employment creation over the next decade. Again, consistent with the experience of other countries, about 99% of firms in the U.K. have a turnover of less than £10m. In short, all but 1% of businesses in the U.K. are either small or medium sized (HMSO, 1993).

A key issue concerning both central and local government authorities in the U.K. refers to the conversion rate between small, medium and large sized businesses. In particular it is believed that the existing rates are below those of which the economy is capable. Many firms with viable growth potential do not realise it, either out of choice or because of constraints to the growth process. Evidence suggests that only around 10% of businesses in the U.K. have the desire to grow and only about 10% of these, (i.e. 1% of the total) will actually proceed to achieve their potential (Hakim, 1989). The problem here is to identify

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first why so many firms have no wish to grow, and second why many of those who wish to do so are constrained in practice. Some businesses do not have the potential to grow and others are run by owner/managers and families who have no desire for their business to grow beyond the size which they feel they can control personally. There are other firms, however, who may resist the option to grow because of the complexity and pressures of the processes concerned. The constraints which may prohibit growth in some cases can also discourage any attempt to grow in others.

The main constraints to growth in U.K. SMEs are thought to arise primarily from three main sources, management and labour skills, regulation and access to finance (ICAEW, 1996). Growth is a complicated and testing process for many businesses and the management concerned may not possess the requisite skills and competencies to achieve successful growth in a sustained way. Managing growth is very different to managing a stable business. Evidence also suggests that skill shortages will often impede the progress of many businesses. If the available labour force does not possess the requisite skills then it is incumbent upon business to introduce training procedures if they wish to grow further. Many firms are resistant to the provision of training since the investment in human capital which it constitutes can then enable the individuals concerned to demand a higher income or move to another business where this can be achieved.

Equally significant may be the various regulatory duties and requirements (Customs and Excise, EC rules etc.) which are often proportionately more restrictive and burdensome for the smaller business. There is also a considerable body of evidence both in theory and in practice to suggest that SMEs will often find it difficult to attract the levels of external finance required to fund the growth process. Whilst all of the above sources of constraint are highly significant it is the main purpose of this paper to address the last of these which refers to the problem of access to finance.

3. The financial constraint

Evidence suggests that for the vast majority of businesses which are young and small, it is unrealistic to expect growth to be funded from internal sources unless large elements of personal equity are available from owners, family or friends. In the absence of sufficient retained profits, firms with aspirations to grow must gain access to external sources of finance and typically this will be in the form of either debt or equity.

The equity finance threshold

External equity funding is essentially risk capital. The provision of such is contingent upon relinquishing an element of ownership and providing an option to the supplier to participate in future profits and capital gain. As such this kind of finance is unsecured in that, in the event of failure, the value of remaining assets will be shared between the shareholders after satisfying outstanding creditors with prior claims.

Providers of risk capital require a significant amount of detailed information about the business concerned for the purposes of evaluation and monitoring. Evaluation refers to the information which is required to ascertain the quality of the management and the realism and credibility of the business plan. This information is required prior to any decision as to whether to advance funding or not. If the evaluation process satisfies the various performance and assurance criteria required by the potential provider and the project is approved, then further information is required on a regular basis for monitoring purposes. Having attempted to avoid the possible adverse selection of projects (Stiglitz and Weiss, 1981) it is then incumbent upon the provider of funds to ensure that the project proceeds as predicted. Monitoring information is required to ensure that the moral hazard of behaviour change in management and ownership as a result of the injection of external equity does not occur or threaten materially the predicted progression of events that satisfied the evaluation process (Chan and Thakor, 1987).

Information for evaluation and monitoring purposes is costly to collect both in terms of time and money. As a result of these information costs there is effectively a threshold below which most formal institutional providers of external equity will not consider projects. In the U.K. it is estimated that this threshold refers to a project funding level of around £250,000. For many small and some medium sized enterprises this threshold means, in effect, that external finance is only available in the form of debt (Mason and Harrison, 1994).

The debt security constraint

For the vast majority of businesses seeking debt finance the main source is the banks (Binks and Ennew, 1992). For the purposes here it is assumed that directors and family loans are effectively internal equity provision rather than external debt funding. In considering whether to advance loans to applicants banks can apply one of two main approaches or some permutation involving elements of each.

- The Income Gearing or Prospects Based Approach
  With an income gearing approach the bank's main concern is that the income stream generated by the project is sufficient to cover the interest and capital repayments involved. As such this approach refers to the prospects of the business concerned. The evaluation of the prospects and their confident application to loan evaluation decision making criteria requires similar information to that referred to above with respect to the provision of equity funding. In short, the project must be evaluated and also monitored as it proceeds if it is successful in attracting funding. The information costs involved are substantial and significant particularly in the case of smaller businesses. As a result banks will often tend to default to the main alternative approach of capital gearing.

- The Capital Gearing Approach
  In order to avoid the information costs associated with a prospects based or income gearing approach banks will often rely for security upon the provision of collateral. This refers to a first claim upon assets of the business which is sufficient (allowing for realisation costs) to cover the outstanding loan in the event of default. From the perspective of the bank, the provision of security significantly reduces the risk associated with lending and provides a means of incentivising borrowers to perform to the best of their ability (Bester, 1987).

The problem for many small businesses and particularly those with aspirations to grow refers to the way in which business assets must be valued for the purposes of collateral. The purchase of plant and machinery to enable growth will add far less to the value of business assets for security purposes than it does to capital purchase costs. This disparity arises because such assets must be valued in the context of a 'gone concern' or carcass based condition. When valuing the assets, the bank must assume that the business will have ceased to trade and the plant and equipment concerned must be sold off at auction or through other means. Typically the prices realised from this kind of disposal will be well below the value of the assets concerned in the context of a going concern.

For a growing small business the main consequence of this valuation process is that the faster the rate of growth the more rapidly the gap grows between the funds required to purchase additional plant and equipment and the collateral value of the business assets to secure additional debt. As a result many small businesses which are attempting to grow will be required to provide personal collateral and thus erode the limited liability status which they may enjoy. In the event that personal collateral to the levels required is unavailable then debt finance will not be forthcoming and the growth will be constrained. The firms which *a priori* would be expected to be most susceptible to the financial constraints described above will be the smaller, the younger, the more entrepreneurial and those with rapid growth aspirations.

Typically, smaller firms will tend to be more vulnerable because the administrative costs per £ lent will be larger, although for some of the smallest businesses the opposite situation may obtain, in that banks may provide debt finance without any requirement for security since the administration costs of that provision would be prohibitive (Cressy, 1996b). Younger firms are more vulnerable to financial constraints because they have little or no track record (Leeth and Scott, 1989). This suggests that they experience difficulties in attracting debt finance on the basis of past performance and also have insufficient in the way of accumulated assets to provide collateral (Peterson and Raghuram, 1994). In a similar vein, entrepreneurial firms (in the sense of those businesses which are involved with new products and processes), may also experience constraints when attempting to gain access to debt finance due to the lack of familiarity of the provider with the products and processes concerned. Finally, firms with rapid growth aspirations will naturally be vulnerable due to the valuation of business assets for the purposes of collateral (see for example Moore (1993), Himmelberg and Peterson, 1994).

4. Information requirements

The potential for adverse selection and moral hazard problems can, theoretically, result in equilibrium credit rationing (Bester and Hellwig, 1989) and relative costs are such that imperfect and asymmetric information are widely identified as one of the main causes of imperfections in the provision of finance to small firms (Constand, Osteryoung and Nast, 1991; Keasey and Watson, 1993). The high costs of information may restrict the extent to which a bank is willing or even able to gain information about key factors which may influence the lending decision. For example, Cressy (1996b) demonstrates the potential importance of human capital as a factor which determines the survival prospects of a business, but if information problems mean that a loan officer cannot evaluate the skills and abilities of the borrower, any subsequent lending decision could result in restricted access to credit.[1] Thus, it may be argued that the potential for problems to exist in terms of viable smaller businesses gaining access to finance arises primarily from information costs. With the provision of better and more accurate information, potential providers of funds are able to estimate risk more accurately and thus use the prospects of the enterprise more consistently in their evaluation processes. In short, the problem is one of information provision and communication between the parties concerned (Berger and Udell, 1993).

The area for which information is required by the potential providers of external finance to SMEs will include management, markets and finance. Management information will refer to a wide variety of assurances required by potential providers as to the competence, experience and credibility of the management of the business concerned (the human capital of the business). Market information will refer primarily to the conditions for the product or process concerned and also to the supplier markets involved. For the purposes here the main focus is upon the provision of financial information in the form of financial ratios, information and cash flow, profit and loss, balance sheet and forecast, and capital budgets. For the purposes of SMEs, given the equity threshold described above, the prime demand for this information will be from the banks. In this sense the responsibility for both determining and explaining the information required rests with the banks. The suppliers of the information will be the firm and usually the accountant involved in the production of their accounts. Whilst the owner/manager is required to cater for and accommodate the vagaries of a wide variety of markets the accountant is best placed to produce financial information as required by the banks.

Evidence in the U.K. suggests that the co-operation and co-ordination of banks, businesses and their accountants is often lacking. As a result there is a breakdown in communications and the parties concerned, particularly the firms and the banks, operate in an environment of mutual ignorance when it comes to the nature of the information required and the explanation of why and how it would be used (Edwards and Turnbull, 1994).

It is helpful at this point to consider evidence on the relationship between banks and their small business customers. This refers to data which were collected in 1994 from around 6,000 businesses (Binks and Ennew, 1994). The respondents are members of the Forum of Private Business and the information which they have provided has been compared with results from an independent sample of firms. This comparison indicates that the response bias of the data are concerned primarily with borrowing levels rather than attitudinal differences. The information presented below may be considered, therefore, to be broadly representative of small businesses in the U.K. which rely on their banks or borrow from them to a larger extent than is typical of businesses in general.

5. Evidence on the bank/small firm relationship in the U.K.

Four surveys of the membership of the Forum of Private Business have been undertaken since 1988

TABLE I
Ranking of main constraints in 1988, 1990, 1992 and 1994

	1988		1990		1992		1994	
	% citing	Rank	% citing	Rank	Mean score[a]	Rank	Mean Score[a]	Rank
Collateral	14.20	3	13.60	3	2.72	3	2.99	4
Interest Rate	19.70	2	37.20	1	3.18	2	3.22	2
Credit availability	12.90	4	3.70	4	2.65	4	2.88	5
Charges	30.70	1	26.60	2	3.23	1	3.53	1
Competence of manager	6.90	5	2.70	5	2.24	6	2.56	6
Speed of service	1.50	6	1.10	6	2.12	7	2.52	7
Term of loan	0.70	7	0.10	7	2.60	5	–	–
Termination of overdraft	–	–	–	–	–	–	3.00	3

Note: Where one item is ranked above or below another it indicates a statistically significant ($p < 0.05$) difference (based on either chi-square tests for 1988 and 1990 or pairwise t-tests for 1992 and 1994). Identical rankings indicate no statistically significant difference.
[a] Mean scores based on a scale 1 = very helpful to 5 = very harmful.

(Binks, Ennew and Reed, 1988, 1990, 1992; Binks and Ennew 1994) to monitor the relationship between banks and small businesses. Table I provides information on the responses to questions about the extent to which bank policies and practices constrain small businesses. What is clear from these data is the predominance of concern with bank charges and interest rates with some concern being shown for collateral, and, in the last survey in 1994, termination of overdraft.

The high level of concern about bank charges may arise for two main reasons. First it is a concern which may affect all respondents whether they borrow or not. Second, this response implies that firms do not understand why bank charges are at the levels that obtain. Despite recent changes in procedures by banks to explain the levels of charges, it would appear that there is still a significant lack of transparency in this pricing process.

The discussion in the previous sections suggested that there would be a tendency for banks to rely on a capital gearing approach to loan evaluation on the grounds that collateral provided a means of compensating for the uncertainties introduced by information asymmetries. Indeed in such circumstances, personal collateral may be particularly appealing given its potential to incentivise owner managers. Although it is difficult to measure the extent to which there may be an over-reliance on collateral, it is interesting to note in Tables II and III, the relatively large proportion of loans and overdrafts which are securitised.

Although direct measurement is difficult, the evidence above does tend to suggest that there is still a high degree of dependence on a capital gearing approach to loan evaluation and that by implication, there is the potential for growth prospects to be constrained. However, a good working relationship which encourages the flow of information between bank and small business may serve as an alternative to a heavy reliance on

TABLE II
Type of collateral on overdraft (% of respondents)

	1988	1990	1992[2]	1994
Personal	n/a	31.8	32.4	30.2
Business assets	n/a	24.9	28.2	25.1
Business and personal	n/a	25.5	30.7	30.3
None	n/a	17.9	8.7	14.4
Number	n/a	3315	4692	3486

TABLE III
Type of collateral on loan (% of respondents)

	1988	1990	1992[3]	1994
Persona	l23.2	28.5	27.1	25.8
Business assets	27.2	31.5	32.3	31.3
Business and personal	22.4	23.5	29.4	32.2
None	27.3	16.5	11.2	10.7
Number	872	1721	2603	2142

asset back lending decisions. Thus, any attempt to examine the financing of small business would be incomplete without an examination of the nature of the banking relationship.

A key feature of the FPB survey was the collection of data about the nature of the relationship between banks and small businesses. This data provides a basis for examining information flows and communication between the two parties. The subsequent analysis seeks to examine more carefully the extent to which there is evidence of a closer more participative relationship generating a more understanding and potentially more productive working partnership.

Cluster analysis was used to identify whether or not there existed distinct groups of firms which differed in terms of their willingness to participate in the banking relationship. The choice of clustering variables was guided by the concept of participation, subject to constraints imposed by available data. Clearly participation is a multifaceted concept, but its essential elements were held to be a willingness to communicate and a willingness to share information. Accordingly, three relationship variables were selected for the analysis on the grounds that they provided a parsimonious specification of these essential elements. The variables used were as follows;

BMINFO: Important to provide bank manager with regular and timely management information

BMAVOID: Prefer to avoid contact with bank manager

BMLIMIT: Important to discuss excess borrowings with bank manager

Each variable was measured on a scale from 1 = strongly agree to 5 = strongly disagree. An iterative partitioning algorithm was used because of the large sample size and 2, 3 and 4 cluster solutions were examined. The two cluster solution presented in Table IV was considered most appropriate on grounds of interpretability and parsimony.

A one-way analysis of variance confirmed that the mean scores on the clustering variables were significantly different between the two clusters. Two additional approaches were used to validate the cluster solutions. First, a series of 10 random samples from the original data set were subjected to a hierarchical cluster analysis and the assignment of case to clusters was found to be identical in 79% of cases. Second, discriminant analysis was used to assess the extent to which the cluster variables predicted cluster membership. The resultant discriminant function produced a 99% correct classification.

The two clusters solution was then used as the basis for subsequent analysis. Cluster 1 was labelled non-participative and cluster 2 was labelled participative. Firms in cluster 1 were generally less willing to provide information to their bank manager, were less inclined to discuss excess borrowings in advance and were more inclined to avoid contact with their bank manager when compared with firms in cluster 2. There was no evidence of any variations in the regional distribution of firms in the two clusters but there were size and sectoral differences. Specifically, non participative firms were rather more prevalent in the Distribution sector and tended to be smaller firms. In addition, it was found that a larger proportion of non-participative firms were experiencing negative growth rates.

With regard to basic financing terms and conditions, there is limited evidence of differences between the two clusters. Only in relation to interest rate charged is there any evidence that willingness to participate affects a core product characteristic. A comparison of means suggests

TABLE IV
The cluster solutions

	Mean score					
	Name	BMINFO	BMAVOID	BMLIMIT	%	N
Cluster 1	Non participative	2.99	2.73	2.32	38.2	2012
Cluster 2	Participative	1.94	4.45	1.58	61.8	3253

that (controlling for other relevant factors) participative firms generally have a lower margin over base (3.22% compared with 3.38%) although the difference is not large. Evidence of a participation effect in this area may be of some importance. Given the role of interest rate in accommodating risk, the more participative firms may be able to increase both the volume and quality of information available to bankers and thus benefit from lower prices as a result of more accurate assessments by the bank of the risk potential of the business. However, such a conclusion must be considered as tentative at present since the evidence of direct benefits (in financing terms and conditions) to participation is limited.

However, there is rather more evidence of a 'return' to participation if we examine the broader aspects of service delivery. As Tables V, VI and VII show respondents categorised as 'participative' and 'non-participative' were divided in their perceptions of the service provided by their bank. Tables V and VI examine aspects of the service considered to be important and perceptions of the quality of provision.

The first five items in the table are aggregate dimensions derived from a factor analysis of 19 aspects of bank service (see appendix 1 for the categorisation); the remaining three are the individual items relating to realistic collateral, competitive interest rates and the average of competitive and predictable charges. Participative businesses were more inclined to appreciate the importance of many of the characteristics of bank service as well as being more positive in their perceptions of quality. Interestingly, the results provide evidence to suggest that the participative firms believe that they receive much better quality with respect to charges and interest rates, offering at least subjective evidence of a 'return' to participation. In addition to higher perceived quality, more participative respondents also perceived themselves to be less constrained in their relationship with their bank as Table VII shows.

The questionnaire also enabled a direct analysis of the relationship between the business and the its bank manager. Again, using factor analysis, a series of items were grouped into three main categories, namely trust and confidence, information flows and approachability (see Appendix 1). With rescaling, the higher mean scores in Table

TABLE V
Importance of service
(mean scores, 1 = not important to 5 = very important)

	Non-participative	Participative
Basic product	3.92	4.23*
Price	4.39	4.49*
Knowledge and understanding	3.59	3.96*
Operations	4.34	4.39*
Accessibility	3.70	3.54*
Interest rates	4.34	4.51*
Transaction charges	4.42	4.48*
Collateral	3.98	4.31*

* Difference is statistically significant – independent samples t-test, $p < 0.05$.

TABLE VI
Quality of service
(mean scores, 1 = very poor to 5 = very good)

	Non-participative	Participative
Basic Product	2.87	3.26*
Price	2.67	2.94*
Knowledge and understanding	2.39	2.93*
Operations	3.32	3.67*
Accessibility	3.28	3.51*
Interest rates	2.63	2.91*
Transaction charges	2.68	2.95*
Collateral	2.58	2.78*

* Difference is statistically significant – independent samples t-test, $p < 0.05$.

TABLE VII
Main constraints
(mean scores, 1 = very helpful to 5 = very harmful)

	Non-participative	Participative
Collateral	3.14	2.91*
Interest rates	3.36	3.14*
Availability of credit	3.02	2.65*
Bank charges	3.71	3.45*
Competence of manager	2.98	2.34*
Speed of service	2.78	2.39*
Threat of termination of overdraft	3.20	2.91*

* Difference is statistically significant – independent samples t-test, $p < 0.05$.

VIII indicate a more positive attitude to the relationship. The following table emphasises the different perceptions of participative and non-participative firms.

TABLE VIII
Banking relationship
(mean scores, 1= negative views to 5 = positive views)

	Non-participative	Participative
Trust and confidence	2.56	3.02*
Information flows	3.25	4.21*
Approachability	2.88	3.94*

* Difference is statistically significant – independent samples t-test, $p < 0.05$

It is important to remember that these relationships do not provide unambiguous data on causality. In some senses it is unsurprising that firms which deal more closely and willingly with their bank are more positive in their attitude towards the relationship concerned. However, what the analysis does demonstrate is the potential return to customers in the sense of a higher perceived quality of service and a better relationship and the potential return to the bank in terms of more satisfied customers and better information.

A similar pattern emerges, when considering the same aspects of the overall banking service for those firms which had considered seriously the prospect of changing banks in the previous year and those which had not. Tables IX and X outline reasons for considering and not considering a change of bank.

As well as the obvious difference in the proportions of participative and non-participative firms which considered changing bank, it is also interesting to note the generally high level of similarity in the reasons given by each group. Perhaps with the exception of high charges (for non-participative firms) and the need for increased credit (for participative firms) there are few substantial differences in the reasons cited by the two groups.

The picture changes somewhat when examining

TABLE IX
Considered changing bank

	Non-participative	Participative
Considered changing bank (%)	53.1	38.3
Considered changing bank (Num.)	906	1348
Reason		
Loan application rejected	10.8	12.3
Need increased credit	20.8	28.0
Bank mistakes	22.0	21.1
High Interest rate	29.2	31.6
High charges	68.8	56.5
Approached by another bank	6.5	11.5
Poor relationship	36.2	34.6
Other	13.6	16.8

TABLE X
Not considered changing bank

	Non-participative	Participative
Not considered changing bank (%)	46.9	61.7
Not considered changing bank (Num.)	801	2176
Reason		
No difference	47.8	33.4
Satisfied	44.6	60.3
Effort and difficulty	25.7	19.9

reasons for not considering a change of bank. Participative firms are more satisfied with their banks performance and are less likely to perceive no differences between banks. By contrast, non-participative firms tend to avoid the potential for changing banks for rather more negative reasons – i.e. the effort and difficulty involved and the belief that there is no difference between banks.

Tables XI to XIV examine the differences in perceptions of bank services and the banking relationship for those who had and those who had not considered changing bank. Again, a consistent pattern emerges with those customers who had not considered changing bank having much more favourable views of their bank and their bank manager.

It is significant that a high proportion of respondents had considered seriously changing their

TABLE XI
Importance of service (mean scores, 1 = unimportant to 5 = very important)

	Considered changing bank	Not considered changing bank
Basic Product	4.17	4.06*
Price	4.53	3.38*
Knowledge and understanding	3.90	3.76*
Operations	4.38	4.37
Accessibility	3.62	3.59
Interest Rates	4.51	4.37*
Transactions charges	4.55	4.39*
Collateral	4.28	4.11*

* Difference is statistically significant – independent samples t-test, $p < 0.05$.

TABLE XII
Quality of service (mean scores, 1 = very poor to 5 = very good)

	Considered changing bank	Not considered changing bank
Basic Product	2.72	3.44*
Price	2.45	3.15*
Knowledge and understanding	2.30	3.09*
Operations	3.18	3.84*
Accessibility	3.26	3.57*
Interest rates	2.39	3.14*
Transactions charges	2.48	3.15*
Collateral	2.33	3.00*

* Difference is statistically significant – independent samples t-test, $p < 0.05$.

TABLE XIII
Main constraints (mean scores 1 = very helpful to 5 = very harmful)

	Considered changing bank	Not considered changing bank
Collateral	3.38	2.69*
Interest rates	3.60	2.92*
Availability of credit	3.30	2.38*
Bank charges	3.92	3.23*
Competence of manager	3.11	2.14*
Speed of service	2.90	2.24*
Threat of termination of overdraft	3.44	2.67*

* Difference is statistically significant – independent samples t-test, $p < 0.05$.

TABLE XIV
Banking relationship (mean scores, 1 = low agreement to 5 = high agreement)

	Considered changing bank	Not considered changing bank
Trust and confidence	2.45	3.18*
Information flows	3.85	3.93*
Approachability	3.22	3.84*

* Difference is statistically significant – independent samples t-test, $p < 0.05$.

bank. That nearly half of respondents reacted in this way is indicative of problems in the small business/bank relationship. Second, the evidence is clear in the association between high levels of participation in the relationship and a more positive outcome in terms of the perceptions of respondents. Clearly, it is difficult to identify precisely the direction of causality; those firms which are more participative may be so because they have been offered better terms and conditions. Equally of course, they may receive better terms and conditions because they have been more willing to share information with their banks. Intuitively, there would appear to be a strong case for believing that there will be elements of both in the development of close working relationships between banks and smaller businesses and that both parties will have some responsibility for developing and maintaining better information flows where appropriate.

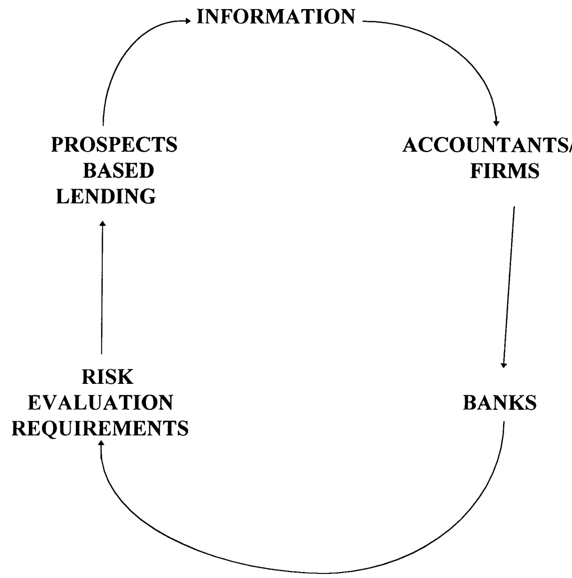

Fig. 1. The learning cycle.

The virtuous circle of information and communication

The evidence presented above suggests there may be significant benefits from improvements in the relationships between banks and their small business customers and the provision and use of relevant information will be central in this process. Information is the key to the more accurate measurement of risk and the more efficient allocation of finance to SMEs. Accountants and firms are reliant upon each other to provide the information to the banks in order that they are able better to evaluate the risks involved. The better informed the banks the more they will be able and confident to apply prospects based lending methods rather than using collateral as the main source of security. In the application of prospects based lending they will also discover further information requirements to improve the processes and methods which they apply. Thus the information requirements from accountants and firms will change, the provision to banks will improve, the risk evaluation requirements will become more accurate and the facility to apply prospects based lending will grow. Since economies are ever changing rather than static, it is crucial that this virtuous circle exists and develops so that it operates to accommodate changing market conditions and retain prospects based lending evaluation procedures as much as is practical within the provision of finance to small businesses.

Conclusions and recommendations

The arguments and evidence presented above suggest that banks and their small business customers could benefit from closer more informed relationships. It is important to qualify this observation in two ways. First, it should be noted that the majority of small businesses do not need a close relationship with their bank because the services which they require are mundane and provided in an efficient and orderly manner. What is clear from the above evidence is that a more positive approach by firms to their relationship with their bank, however deep or undemanding this may be, is associated with perceptions of higher quality, less constraint and lower propensity to consider switching bank.

In developing their relationship with small businesses, it is clear that banks need to be selective when applying this strategy since it is costly in terms of peoples time. Second, it should be noted that the need to improve relationships is based primarily upon communication and the exchange of information. Developments in information technology, intelligent systems and credit scoring models are important considerations in these processes. Such developments should not be interpreted in a simplistic way. It is very tempting to extrapolate existing trends to the point where bank staff and small business managers communicate electronically without the need for personal contact. It is doubtful for the minority of businesses who require a relationship banking approach that such a vision is likely to be desirable or appropriate. Although mistakes will be made in the application of IT provision and its usage, there is also significant potential for time-saving and efficiency gains through the judicious use of many of these developments.

In terms of policy formulation it is sensible for central and local government to consider some of the initiatives currently being tested by U.K. banks. For example, both National Westminster and Lloyds are trialing loan assessment and information provision procedures which trade off information provided with the cost of the loan at the margin. These schemes may fail simply because the amounts involved are relatively small; the underlying principle, however, is sensible in that information provision will only improve if firms are motivated by sufficient incentive. If the ability to start a business were tied to particular provisions, then the high failure rate in the U.K. may be reduced and the volatility and inconsistency of bank provisions might be improved.

Appendix 1

Categorisation of bank service attributes

The following categorisation was derived for a factor analysis (principal components extraction, varimax rotation) of the importance and perceived quality ratings. The factor solutions were identical for both data sets producing the groupings listed below.

Basic product
- Availability of credit
- Realistic collateral
- Speed of service
- Tailors finance to needs of business
- Deal with one person
- Easy access to loan officer

Price
- Competitive charges
- Predictable charges
- Competitive interest rates

Knowledge and understanding
- Knows business
- Knows industry
- Knows market
- Offers helpful advice

Operations
- Deals efficiently with queries
- Reliable and accurate
- Friendly and helpful staff

Accessibility
- Convenient branch location
- Long and convenient opening hours
- Wide range of services

Categorisation of bank manager relationship

The following categorisation was derived from a factor analysis (principal components extraction, varimax rotation) of a series of Likert scaled statements about the respondents relationship with their bank manager.

Trust and confidence
- My bank manager is always available to help in a crisis.
- My bank manager comes forward with positive suggestions to help my business.

I am confident in the advice I get from my bank manager.
I am confident that my bank understands small businesses.
I can rely on my bank manager to find ways of meeting my business's changing financial needs.

Approachability

I prefer to avoid contact with my bank manager.
My bank manager is not really interested in my business.
I feel intimidated when dealing with my bank.
My bank manager is only prepared to offer standard financial small business products.

Information flows

It is important to provide my bank manager with timely and regular management information.
It is important to discuss in advance potential excesses over agreed borrowing limits.

Notes

[1] We refer to a situation in which a proposal would be viable but funding is not provided because high costs mean that there is inadequate information available to illustrate the viability of the project and the skills of the proposer.
[2] The nature of the question was changed in the 1992 survey. Prior to that it had requested respondents to indicate their main constraint whereas subsequently they were asked to grade each listed constraint in terms of impact.
[3] Due to slight changes in the wording of the 1992 questionnaire, the collateral type figures are not strictly comparable and so instances where 1992 diverges from the other years should be interpreted with care.

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