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Does the quality of lender–borrower relationships affect small business access to debt? Evidence from Canada and implications in China☆

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ABSTRACT

The literature on corporate governance and entrepreneurial finance suggests that when lender–borrower relationships are of longer duration, they tend to be more successful in solving the informational asymmetry problems related to small business debt financing. Using the data from Canadian financial markets, this study first confirms this finding, insofar as the quality of lender–borrower relations is affected by traditional solutions to agency conflicts, lender requirements, and negative changes in the borrowing terms offered by lenders. However, in testing this conclusion further, we empirically demonstrate that, counter-intuitively, the quality of the lender–borrower relationship does not affect a small firm's access to debt, or change the terms of borrowing. We also show similar supporting evidence from lenders to small firms in China, where business relationships involving "guanxi" (or connections that are beneficial for both parties) are commonly expected to influence access to debt. The robustness of the study's results is shown by the data from numerous lending institutions in a province of China.

1. Introduction

The literature on debt financing tends to follow two complementary directions. One direction of investigation addresses a trade-off between the benefits of leverage and of bankruptcy risk, which is usually measured by cash flow volatilities. The other direction focuses on the agency problems caused by the asymmetry of information between borrowers and lenders. Finance scholars have extensively studied the lender–borrower agency conflict for large, publicly listed companies, as abundant data from such firms is available (Bhattacharya & Thakor, 1994; Harris & Raviv, 1991; Petersen & Rajan, 1994). We believe, however, that further exploration is needed in the field of small business debt financing if we are to gain a clearer, more comprehensive picture (Bartholdy & Mateus, 2011).

As heightened informational asymmetry problems are more common for smaller, private firms than for larger, public firms, many scholars have suggested that such problems can be overcome through forming long-term lender–borrower relationships. These scholars have proposed that quality relations with lenders can be an important and useful tool in helping small firms to successfully access debt financing (Petersen & Rajan, 1994). More traditional solutions to lender–borrower agency problems have included bonding, screening, monitoring and signaling (Berger & Udell, 1995, 1998; Diamond, 1984; Petersen & Rajan, 1994, 1995). However, a pioneering study by Allen and Gale (1999) discussed the importance of long-term relationships between financial intermediaries and their customers. In a seminal work on entrepreneurial finance, Shane and Cable (2002) addressed how entrepreneurs use social ties to overcome financing difficulties. Another study by Arena (2011) looked at the credit quality of firms as a determinant of the types of debt financing sought. Both Petersen and Rajan (1995) and Boot and Thakor (2000) discussed the viability of relationship-based lending in the face of increased competition. In response to these investigations, we believe that our study fills an existing gap and adds to the growing literature on the effects of lender–borrower relationships on small business debt financing.

Using data from Canadian financial markets, we seek to explore whether the quality of lender–borrower relationships is a determinant of debt access for small firms, and whether relationship quality affects lenders' decisions concerning changes to the terms of financing or lending. As the quality of lender–borrower relationships is influenced by traditional agency tools for solving informational asymmetry problems, lenders' requirements, and negative changes in borrowing terms, we take these factors into consideration (Sharpe, 1990). Our empirical results show that after controlling for these interactions, the quality of

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lender–borrower relationships has no significant influence on lenders' decisions to change borrowing terms or determine access to debt for small firms. The implications of these findings are further explored through a survey of lending practices in the "guanxi" relationship-based society of China. The results in China are comparable to the Canadian findings, partly because the banking industries in both China and Canada are highly concentrated (unlike the banking industry in the United States) (Zhang, Jiang, Qu, & Wang, 2013). According to the data collected from lending institutions in Yunnan province of China, only 7.8% of the lenders surveyed viewed the lender–borrower relationship as important in making decisions on loan applications from small businesses. This observation indicates that our findings are also applicable for small business debt financing in China.

This study makes theoretical and practical contributions to the literature in several ways. First, as far as we are aware, this is the first study to examine how the quality of lender–borrower relationships affects small business debt financing. Thus, our study contributes to both the entrepreneurial finance literature and the theory of corporate governance. Second, our study supplements the finance literature on credit and agency problems, as it investigates a dimension of lender–borrower relationships that has been largely ignored in prior research on informational asymmetry problems. Third, our findings have regional implications for both mature and emerging markets in the Asia-Pacific region, where similar corporate governance mechanisms prevail. These implications are especially important for small businesses, which play an important role in the global economy (Cavalluzzo, Cavalluzzo, & Wolken, 2002; Coleman, 2002).

The study is organized as follows. In Section 2 we discuss the conceptual basis for the study. Methodologies are introduced in Section 3, after which Section 4 presents and discusses the results. Supporting evidence from China is presented in Section 5. Our conclusions are presented in Section 6.

2. Theoretical background

Agency issues have long been recognized, and have drawn significant attention since the concept of asymmetric information was proposed in a Nobel-prize-winning article by Akerlof (1970). Ross (1973) formalized the principal-agent problem, which had been first addressed by Berle and Means (1932). Jensen and Meckling (1976) used the term "agency costs" in addressing the theory of firms and their decisions regarding capital structure. Among the three major dimensions of agency problems that affect company decision-making, the lender–borrower agency conflict is the most critical for capital structure decisions (Myers, 1977; Smith & Warner, 1979; Stiglitz & Weiss, 1981). The other two agency problems are owner–manager agency conflict, and conflicts between majority and minority shareholders.

Recent theories in the field of debt financing have focused on explaining and mitigating the agency problems that arise from asymmetric information between lenders and borrowers (Harris & Raviv, 1991). Such prior work has focused mainly on large, publicly listed companies. Studies related to small businesses have been infrequent due to the lack of data (Shleifer & Vishny, 1997). However, the lender–borrower agency conflict is especially significant for small businesses, because of the superior information held by small businesses owners. Previous studies have also noted that the risks considered by lenders in small business debt financing go beyond assessing default risk, as small business owners cannot usually access long-term debt, even if they are willing to pay higher prices for it (Cavalluzzo et al., 2002).

Therefore, finding effective solutions to the lender–borrower agency problems faced by small firms is of practical importance. The traditional finance literature (Harris & Raviv, 1991) has suggested bonding and monitoring as solutions for moral hazard problems (Smith & Warner, 1979). Some studies have suggested signaling as a means for dealing with adverse selection issues (Stiglitz & Weiss, 1981). In past efforts to get more information and help small business borrowers, the entrepreneurial finance literature (e.g., Berger & Udell, 1995; Petersen & Rajan, 1994) has indicated that better quality lender–borrower relationships may be useful tools for mitigating the agency conflicts between these two parties, especially when traditional approaches are unavailable or ineffective.

The length or duration of lender–borrower relationships has been considered a significant factor in helping small business owners to successfully access debt financing. However, due to the lack of data in this area, the actual effect of relationship duration has not been examined in depth. In this exploratory study, we examine whether the quality of lender–borrower relationships affects lenders' decisions concerning changes in borrowing terms and/or debt access for small firms. We make this investigation while taking into account the influence of other factors on these relationships. Accordingly, we propose the following two hypotheses.

Hypothesis 1. A higher quality lender–borrower relationship facilitates access to debt by small business owners.

Hypothesis 2. A higher quality lender–borrower relationship mitigates the likelihood of negative changes in borrowing terms offered by lenders.

3. Methodology

On behalf of Industry Canada, in 2001 the Research Institute for Small- and Medium-sized Enterprises (SMEs) at the University of Quebec collected data from a survey entitled "Financing Canadian SMEs: Satisfaction, Access, Knowledge and Needs." The population surveyed consisted of small Canadian firms with fewer than 500 employees. Non-profit organizations, holding companies, franchises or firms involved in outsourced government administration services were excluded. The researchers used survey instruments sent by mail with follow-up telephone interviews. Of the 10,020 companies surveyed, the 2116 that responded were included in the database. The survey questions provided useful variables and rich information for our study. We therefore considered these survey data ideal for answering the research questions asked above, and for testing the two hypotheses proposed earlier.

3.1. Variables

3.1.1. Dependent variables and main independent variables for testing Hypotheses 1 and 2

Two dependent variables were used to test the hypotheses. These were (1) the amount of debt to which small firms have access (ACCESS), and (2) the negative changes in borrowing terms offered by lenders (NC).

Following Berger and Udell (1995, 1998) and Wu and Chua (2012), we focused on the line of credit (LOC) to examine how the quality of lender–borrower relationships influences the terms of borrowing. The major reason for this focus was that the LOC is a typical short-term debt financing instrument used by small business owners. Also, the owners commonly use renewals of LOCs to serve as their method of long-term debt financing (Berger & Udell, 1995, 1998).

In Hypothesis 2 we conjectured that the quality of the lender–borrower relationship mitigated the probability of changes in borrowing terms. As LOCs are a form of short-term financing, their terms can be easily and quickly changed by the lenders according to economic conditions. During renewal, frequent interactions between lenders and borrowers occur. Such interaction may help to disclose superior information previously held exclusively by the small business owners. In this study, therefore, the LOC was considered to be a valid representative of small business debt financing.

Following the literature on small business financing, the variable ACCESS was measured by the ratio of total liabilities over total assets.