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IS RELATIONSHIP LENDING PRACTICAL? THE USE OF RELATIONSHIP LENDING MEASURES IN SMALL AND MEDIUM ENTERPRISE (SME) LENDING: A MULTIPLE CASE STUDY OF COMMERCIAL BANKS IN KENYA.

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Abstract

The subject of small and medium enterprise (SME) lending has attracted a lot of interest from both academics and policy makers as access to finance for these enterprises is necessary to ensure their continued contribution to the economic development of most economies. Due to the informational opaque nature of SMEs, relationship lending is a method that is considered appropriate for use when lending to these enterprises. As relationship lending is difficult to measure, it has been proxied by certain measures the most common being; duration, scope and, concentration of borrowing. Previous studies, employing a quantitative approach, have been carried out to determine the relationship between these measures and SME lending terms for the borrower and have resulted in contrasting results. The use of an in-depth qualitative study is therefore considered, to explore the supply side (commercial bank) perspective on how these measures affect the SME lending decision. The objective of this study is to determine whether commercial banks in Kenya employ relationship lending. Data is collected through semi structured interviews and analysed using content analysis. The results reveal that commercial banks do use the measures suggested in literature as indicators of the practice of relationship lending but to a large extent with other considerations. The study concludes that relationship lending is practised by the selected commercial banks in Kenya.

Keywords

Relationship lending – duration – scope - concentration of borrowing.

JEL Classifications

G21 - D82

1.0 Introduction

In its simplest form, the primary role of a bank is to bring together those who have excess funds to save and those who need to borrow. This role of a bank as an intermediary is similar to a securities market where financial contracts are created to facilitate the movement of funds between savers and borrowers. Modern banks have been seen to act beyond this simple execution of financial contracts, in the instances where they accordsome flexibility to their borrowing customers (Ongena, 2000). This flexibility occursif a relationship has been forged between the bank and its borrowing customer. Banks may develop relationships with their borrowing customers in the hope of doing increased business with them in future and as such apply the lending technology that is commonly referred to, in literature, as relationship lending (Greenbaum & Thakor, 1995; Elsas, 2005, & Freixas, 2005). Banks have several options they can apply to gather information from their borrowing customers; they can require financial statements, collateral and/or credit scores or alternatively they can rely on the personal relationship that they have developed over time with the borrower (Elyasani & Goldberg, 2004; Berger & Udell, 2006). The relationship method works when information is not readily available from the use of the other options. Relationship lending focuses on asymmetric information problems associated with firms, especially small firms (McNulty, 2002). In most cases, small firms are relatively young and therefore have no past history from which banks can make decisions about expected future performance. Additionally, most of these small firms lack collateral to pledge for loans (Garriga, 2006). These firms therefore have often been labelled as informational opaque compared to their larger counterparts who compete for the same funds. Due to the informational opaque nature of small and medium enterprises (SMEs), relationship lending is a method that is considered appropriate for use when lending to these enterprises (Carbo' -Valverde, Rodri'guez-Ferna'ndez, & Udell, 2009; Elyasani & Goldberg, 2004; Ono & Uesugi, 2009). Due to their small size and lack of substantial public information about their quality, such firms lack access to external funds, for instance, through issuance of debt or equity securities, they therefore tend to be dependent on banks for external funds. The subject of SME lending has attracted a lot of interest from both academics and policy makers as access to finance for these enterprises is necessary to ensure their continued contribution to the economic development of most economies. Relationship lending is a method that if applied could lead to increased financing for these enterprises; however whether this method is applicable is a question that needs to be answered (Calice, Chandoa nd Sekioua, 2012).

2.0 Literature Review

Several researchers provide complementary definitions of relationship lending. Petersen and Rajan (1994) define relationship lending as when a firm has close ties to a financial institution. Ongena & Smith (2000) refer to relationship lending as the connection between a bank and a customer that goes beyond the execution of simple, anonymous financial transactions,while Elsas (2005) refers to it as a long term implicit contract between a bank and its debtor. Schwarze (2006) suggests that the more qualitative information is used in credit decision making the more one can speak of granting of credit under relationship aspects.Using this information over several interactions can be beneficial to both bank and customer (Greenbaum & Thakor, 1995). As relationship lending is aimed at resolving information asymmetry problems, it is suited to SMEs which are considered as informationally opaque enterprises (Carbo' –Valverde et al., 2009; Ono & Uesugi, 2009).

According to empirical literature,relationship lending is a complex phenomenon that is difficult to measure and thus has been proxied by different aspects (Presbitero & Zazzaro, 2009). Elsas (2005) argues that it is not clear which proxies should be used for relationship lending and suggests that directly asking one of the involved parties is a straightforward way to generate a criterion for assessing whether a given bank-borrower relationship is "special" in the sense of relationship lending. More recently, Santikian (2014) emphasizes that even though banks are a primary source of capital for small, private firms, the inner workings of small firms' bank relationships remain obscure. Most of the prior studies on relationship lending have focused on three aspects or measures of this lending technology; duration, scope and concentration of borrowing (Degryse & Van Cayseele, 2000; Elsas, 2005; Iturralde et al., 2010; Lehmann & Neuberger, 2001; Ongena & Smith, 2000).

Duration is the most widely used measure of relationships and reflects the length of time that the bank has provided loan, deposit, or other services to the firm (e.g. Berger & Udell, 1995; Elsas, 2005; Ongena & Smith, 2000; Petersen & Rajan, 1994). Theoretically, there is a positive relationship between duration and information flow which should improve the bank's willingness to provide funds and thus availability of finance to the borrower (Berger & Udell, 2002; Degryse & Van Cayseele, 2000). Berger and Udell (1995) examine the role of relationship lending in small firm finance and find that borrowers with longer banking relationships pay lower interest rates and are less likely to pledge collateral. Similarly, Boot (2000) finds that apart from a fall in interest rates and collateral requirements over the life of the relationship, duration positively affects the availability of credit, concurring also with the earlier findings of Petersen and Rajan (1994) and Cole (1998) who find that in the US, a lender is less likely to grant credit to a firm if the customer relationship has lasted for one year or less. Contrasting evidence is provided by Degryse and Van Cayseele (2000) who in a study of Belgian enterprises on the impact of relationship banking find that borrowing rates increase as the bank-firm relationship lengthens, while borrowing rates decrease when the scope of the bank-firm relationship increases.

Scope reflects the breadth of the relationship, that is, the number of different services or interaction over multiple services between the bank and the customer (Nakamura, 1993; Cole, 1998; Degryse & Van Cayseele, 2000). Information gathered from the interaction may not only have an effect on the credit terms with the borrower, (Degryse & Van Cayseele, 2000; Santikian, 2009) but may also affect the bank's comparative advantage in lending. Earlier, Hodgman (1961) hypothesizes that a customer's deposit relationship with the bank influences the availability and cost of credit to that customer and leads to more favourable loan conditions for a customer than a noncustomer. Subsequently, Wood (1975) proposes that a lending relationship may develop independently of a deposit relationship and recognises that banks may want to accommodate prospective borrowers so that they can capture these customers for future credit.

Concentration of borrowing is the number of bank relationships that a borrower maintains (Harhoff and Körting, 1998; Ongena and Smith, 2000). Elsas (2005) argues that having one exclusive relationship promotes closer ties between the bank and borrower. Iturralde et al. (2010) suggest that the number of relationships may be influenced by the characteristics of companies and the social and economic environment of a particular country. To determine whether a bank qualifies as a main bank (one which provides 80 percent or more of a firm's products), Degryse & Van Cayseele (2000), look at the scope of the relationship. They further

suggest that a main bank relationship should lead to more accurate information and therefore reduce the bank's monitoring costs in tandem with Diamond's (1984) preposition that a single bank relationship is optimal because it avoids duplication of screening and monitoring efforts. Foglia, Laviola and Reedtz (1998) concur that the larger the number of bank relationships, the higher the riskiness of the borrowers because monitoring of the borrower tends to be weaker.

As the empirical evidence of the applicability of relationship lending as proxied by its measures appears to be mixed (Elsas & Krahnen, 1998), this study sought to explore whether the relationship measures play a role in SME lending in Kenya. Literature suggests that banks in developing countries are more likely to engage in relationship lending. As Kenya is a developing country with a financial system that sees higher deposits in financial institutions and higher levels of credit channeled to the private sector than other Sub-Saharan and low income countries (Beck & Fuchs, 2004), the results of this study should to add to the existing knowledge on relationship lending.The research questions that guided this study are as follows:

RQ1 What is the role of duration in SME lending decision making by commercial banks in Kenya?

RQ2 What is the role of scope in SME lending decision making by commercial banks in Kenya?

RQ3 What is the role of concentration of borrowing in SME lending decision making by commercial banks in Kenya?

3.0 Research Methodology

This study employed a qualitative research approach. Qualitative research is defined as research to explore and understand opinions and have in-depth understanding of a problem. Qualitative research is particularly important when studying the experiences of people in specific settings and is more appropriate when the researcher wishes to study the complexity of something in its natural setting (Howitt & Cramer, 2005).

A multiple case study design was adopted for this study. Miles & Huberman (1994) argue that evidence from multiple cases adds "confidence" to the research findings while Yin (2004) adds that the evidence from multiple cases is often more compelling and the overall study is therefore considered more robust. This is also the appropriate method when the researcher has little control over events and the focus is on a contemporary phenomenon within a real-life context (Yin, 2004). A multiple case study will also enable the researcher to see the differences and similarities among the cases and will increase the level of assurance of findings. The seven commercial banks selected for this study are those that are engaged in SME lending and have been ranked amongst the top three for the years 2011-2014 in a banking survey carried out in Kenya (Banking Survey, 2014, 2013, 2012, 2011). Data was collected through semi structured interviews with sixteen relationship managers/branch managers with each interview lasting between one and two hours. The data was analysed as soon as it was collected so as to maintain accuracy while the data collected was still fresh in the mind of the researcher. Miles and Huberman (1994) explain qualitative data analysis as consisting of three (3) concurrent flows of activity: data reduction, data display and conclusion verification. Data was reduced by selecting, focusing, simplifying, abstracting and transforming the data that appeared in written-up field note or transcription to summaries; displayed in tables that permitted conclusion drawing.

4.0 Summary of Findings and Discussions

RQ1: What is the role of duration in SME lending decision making by commercial banks in Kenya?

The results on how duration impacts lending decisions are summarized in the table 1 below:

Table 1 Summary Duration Effects

Duration Effect Borrower benefit (B) Lender benefit (L)	Respondents[1]	No. of Respondents (without activity - W/o A)	No. of Respondents (with activity-WA)	Total Frequency
Approval (B)	B1a, B5a (WA), B5b (WA), B6c (WA), B7b (WA)	1	4	5
Loan amount (B)	B1b	1	0	1
Loan term (B)	B1b, B6c (WA)	1	1	2
Lower rate (B)	B1b, B6b, B6c (WA)	2	1	3
Information (L)	B1c, B5a (WA)	1	1	2
Waiver on start-up(B)	B3a, B3b (WA)	0	2	2
Lower fees (B)	B6b, B6c (WA)	1	1	2
Lower requirements (B)	B6c (WA)	0	1	1
Slight effect (B)	B7a	1	0	1
Totals		**8**	**11**	**19**

The summary of the interviews show that duration, or the length of time that the bank has provided loan, deposit or other services to the firm, is a consideration in making the SME lending decision for banks as it is considered by five out of the seven banks in the study. However duration is not considered in isolation, 57% of the respondents stipulate that the activity in the account (indicated as with activity – WA) is what matters more when considering an SME lending decision. These respondents explain that activity in the account is more important than duration because as B3a and B3b put it, "duration alone does not necessarily tell us about the activity on the account, you may have had an account for a longer period than another customer but with less activity."The fact that activity is more commonly considered differs with Elsas (2005) who posits that duration is the most widely used measure of relationships because this study reveals that activity in the account is what matters.

[1] The following key is used to identify responses from each bank and specific respondents:
Key:
B1: Bank One;
B1a: Respondent "a" (or first respondent) from Bank One;
B1b: Respondent "b" (or second respondent) from Bank One;
B6c: Respondent "c" (or third respondent) from Bank Six.

The results also reveal that there are benefits of duration for both bank and customer which concurs with Berger and Udell (2002) and Degryse and Van Cayseele (2000) who argue that the consideration of duration results in benefits for both bank and borrower. Further the benefits are greater for customers as only one out of the nine benefits indicated enjoyed by lenders. From the lender's point of view the increased business due to the consideration of duration should lead to lower costs in terms of screening, monitoringand higher profitability for the bank. The most common benefit of duration, indicated by 26% of the respondents representing 57% of the banks in the study, is that it impacts approval of the loan confirming the theory by Berger and Udell (2002) and, Degryse and Van Cayseele (2000) that there is a positive relationship between duration and information flow which should improve the bank's willingness to provide funds and thus availability of finance to the borrower. This finding also agrees with those of Boot (2000) and, Berger and Udell (2002) that duration positively affects the availability of credit. 80% of the respondents qualify that duration is not considered in isolation and in fact activity is what matters and is considered together with duration. Of all the 19 responses received, 18 indicate that duration is important with only one loan manager arguing that duration is only slightly important. The benefits for customers in order of preference are; lower rates (3 respondents from 2 banks), longer tenure (2 respondents from 2 banks), lower fees (2 respondents from 1 bank) and waiver on start-ups (2 respondents from 1 bank). This result agrees with Berger and Udell (2002) who examine the role of relationship lending in small firm finance and find that borrowers with longer banking relationships pay lower interest rates and also Boot (2000) who finds that duration results in a fall in interest rates over the life of the relationship. However, our results differ from those of Degryse and Van Cayseele (2000) who in a study of Belgian enterprises find that borrowing rates increase as the bank-firm relationship lengthens. The only benefit of using duration for banks is that it provides information as indicated by two respondents from two banks which concur with Degryse & Van Cayseele (2000) that there is a positive relationship between duration and information flow.

RQ2: What is the role of scope in SME lending decision making by commercial banks in Kenya?

The results on how scope impacts lending decisions are summarized in the table 4.2 below:

Table 2 Summary Scope Effects

Scope Effect **Borrower benefit (B)** **Lender benefit (L)**	**Respondents**	**No. of Respondents**	**No. of Respondents (with activity-WA)**	**Total Frequency**
Deepens relationship (B & L)	B1a	1	0	1
Borrowing advantage (B)	B1b (WA and type of product), B4a (WA)	0	2	2
No effect	B1c, B7b	2	0	2
Lower pricing (B)	B5a, B5b, B5c, B7a	4	0	4
Concessions (B)	B6c	1	0	1
Totals		**8**	**2**	**10**

The results reveal that 80% of the respondents, representing five out of seven banks in the study, indicated that scope does have an impact on the SME lending decision. However in two of these banks, two respondents state that scope does not impact the lending decision. Additionally, similar to the duration measure, scope is also qualified by some respondents. Two respondents from two banks qualify that scope is considered together with the activity in the accounts while one respondent from one bank qualifies that it is not only scope that matters but also the type of products, preferring loan products.
The results also show that there are benefits of scope for the bank and for the borrower; however benefits for the borrower are more prevalent as only 10% of the respondents indicated a benefit for the bank. The most common benefit for borrowers is that scope leads to lower pricing. This is explained earlier that since scope of products may lead to higher earnings for the bank, from the array of products that the customer is already enjoying, this determines the bank's decision to consider lowering the price of loans or offering some concessions. Other stipulated benefits are borrowing advantage, concessions and a deepened relationship (which is seen as an advantage for both borrower and bank due to the additional benefits that may be gained due to such a relationship) concurring with Degryse and Van Cayseele (2000) and Santikian (2014) that information gathered from the interaction over multiple services between the bank and the customer may have an effect on the credit terms with the borrower.

RQ3: What is the role of concentration of borrowing in SME lending decision making by commercial banks in Kenya?

The results on how concentration of borrowing impacts lending decisions are summarized in the table below:

Table 3Summary Concentration of Borrowing

Concentration Effect	Respondents	No. of Respondents	No. of Banks
Negative	B1a, B4a, B5b,	3	3
No effect	B1c, B6b	2	2
Considered with conditions	B1b (based also on turnovers), B1c, B3a, B3b, B5a, B5c, B6a, B6c, B7a, B7b	10	5

There were mixed responses regarding the impact of concentration of borrowing on the SME lending decision. There were those respondents that indicated that being multi-banked is a negative, that is banks would not lend to such a customer; those that stated that it is neutral and treat the multi-banked customer just like any other that is not; and finally those that consider the multi-banked customer but with conditions. The consensus, which is evident from 87% of the respondents, is that being multi-banked impacts the SME lending decision. 77% of these respondents reveal that the multi-banked borrower is only considered based on certain conditions.The most prevalent condition that is cited by these respondents is the requirement that a minimum percentage of their banking be rerouted to the bank. In most cases this minimum percentage 50% (B3a, B3b & B5a), 70% (B6a) and 80% (B5c) results in the bank ending up being their main banker which concurs with Elsas (2005) that having one exclusive relationship promotes closer ties between bank and borrower. This also concurs with Diamond's (1984) preposition that a single bank relationship is optimal because it avoids duplication of screening and monitoring effort and Foglia, Laviola and Reedtz (1998) who find that the larger the number of bank relationships the higher the riskiness of the borrowers because monitoring

of the borrower tends to be weaker. One respondent also cites that being multi-banked does not matter as much as the turnovers.

What is evident from the above results is that banks, because of the need to grow their business, do not out rightly refuse to deal with a multi banked customer. They listen to the customer, understand their need and agree to lend based on certain requirements. In this way banks are able to on board the customer with a view of eventually attracting most of their banking to them. B6b rationalises this by looking at it from another perspective; that you can have a customer who is faithful to one bank and does banking that is much less than a multi banked customer. What emerges from the impact of concentration of borrowing on the SME lending decision is similar to the conclusion for the other two measures of relationship lending discussed earlier, duration and scope; that concentration of borrowing is not considered in isolation but other factors such as turnovers, reasons why the customer is multi-banked and whether they agree to meet certain conditions come into play.

5.0 Conclusions

The study reveals thateven though commercial banks do consider duration, scope and concentration of borrowing in the SME lending decision, these measures are not considered in isolation but together with other considerations. Duration on its own has no effect and is based on the activity in the account, scope in isolation also has no effect but is based on activity and type of products and finally, concentration of borrowing has an effect on the decisionmaking and for the borrowing firmto be able to receive financing, it has to meet the percentage banking requirements of each bank.

The results also reveal that the consideration of duration and scope results in benefits for both banks and for borrowers which concurs with Greenbaum and Thakor (1995) that using relationship lending can be beneficial to both bank and borrower.

There are mixed responses regarding the impact of concentration of borrowing on the SME lending decision. Despite this, what emerges from the enquiry is that similar to the conclusion for the other two measures of relationship lending, duration and scope; concentration of borrowing is not considered in isolation but other factors such as turnovers, reasons why the customer is multi-banked and whether they agree to meet certain conditions come into play.

The study concludes that commercial banks in Kenya do employ relationship lending to some extent because even though the measures of relationship lending found in literature are considered, these are in most cases used together with other measures, such as activity and performance of the account. This leads to the conclusion that relationship lending is not employed in isolation but in consideration of other factors and recommends a further study to determine how SME lending in totality is achieved by commercial banks.

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