

# ECONOMIC PERSPECTIVE 3

## SMALL FIRMS AND SCOTTISH CLEARING BANKS

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### 1. INTRODUCTION

Concern about the relationship between small firms and clearing banks has resurfaced periodically over many years. In 1991 it has again been prominent, receiving considerable media attention. There is no doubt that the issues raised by the relationship are potentially very significant for the future development of the Scottish economy and accordingly warrant detailed and careful consideration. With this sort of thing in mind, in July 1991 the Association of British Chambers of Commerce commissioned our survey of small firms in Southern England, the English Midlands and Scotland. We posted a questionnaire to 1500 Chambers of Commerce members. This paper examines the 73 responses from small firm customers of Scottish clearing banks.

These responses are discussed in Section 3. Section 2 provides background information by briefly noting major issues of concern (1). (Further information, including technicalities of the survey and more results, is contained in Cowling, Samuels and Sugden (1991).)

### 2. ISSUES OF CONCERN

Recent popular discussion of the small firm/clearing bank relationship has focused on the costs of finance, specifically interest rates and other bank charges. Alongside security requirements, these two issues have often caused particular worry, see for instance Wilson Committee (1979) and Binks, Ennew and Reed (1988). However, extensive research over a long period reveals three, more fundamental characteristics which also stand out for consideration. These are banks' market power, banks' short-termism, and what can be called the "distance" that banks and small firms maintain in their relationship.

For instance Binks, Ennew and Reed (1988) conclude from their extensive survey of small businesses in 1987 "that there is competition between banks, but only at a superficial or 'cosmetic' level". They see this lack of competition as reflected in small firms' lack of movement between banks, for example. As regards short-termism, it is often alleged that there is a "gap" in the availability of longer term capital, see Wilson Committee (1979),

Hall and Lewis (1988) and Binks, Ennew and Reed (1990). British banks' failure to take equity stakes in small firms is part of this alleged deficiency, which is also associated with the view that banks and small firms fail to develop a close relationship. Another aspect of excessive distance is the claim that banks make little effort to understand firms' trading conditions. As Storey (1990) reports, for instance, it has been argued that a bank can require so much security that it sees no need to understand a firm! Also relevant is the view that banks apply a uniform policy and are unable to respond to specific circumstances in particular localities, see for example Bannock (1981). Moreover, the relationship between small firms and banks is necessarily a two-way affair and it is not at all clear that it is only banks who have maintained their distance. For instance Storey (1990) argues that firms could help banks by providing more information and by taking advice. They might also consider equity as a means of generating a closer relationship.

### 3. SURVEY OF SMALL FIRMS

With these issues in mind, we questioned small firms about their activities, experiences and views. Our feeling is that we have sufficient information to provide a worthwhile analysis. Nevertheless care is needed, especially on five counts. Firstly, we have only questioned firms, not banks. Clearly a full understanding of the relationship between small firms and banks requires an appreciation of the banks' positions and views. Secondly, respondents to questionnaires of this sort tend to be those more conscious of and interested in their environment. This implies a disproportionate number of disgruntled respondents, for instance; firms happy with their banks' performance are likely to be under-represented. Thirdly, the excessive attraction to dissatisfied firms is likely to be exacerbated by the media attention given to banks' activities immediately before and during the implementation of the questionnaire. Fourthly, the survey was not posted to a representative cross-section of all types of small firms. For instance, it was confined to Chambers of Commerce members. Fifthly, although the response rate is good and respondents are spread across Britain, the questionnaire was sent out to a limited number of firms in a limited number of areas.

### 3.1 General Information

16.4% of our firms banked with the Clydesdale, 46.6% with the Royal Bank of Scotland and 37% the Bank of Scotland. Easily the most common form of business organisation is the private limited company, 61.6% of respondents. Most other firms are partnerships (21.9%) or proprietorships (13.7%). The dominant sector is (non-financial) services, with 45.2%. Manufacturing accounts for 13.7% and construction for 11%. Approximately 82% of respondents said that they currently employed up to 50 people. Among this 82%, there is a fairly uniform distribution of firms with 0-5, 6-10, 11-20 and 21-50 employees. Only 11% of firms currently employed over 100. As for sales turnover, a mere 5.5% reported sales under £50,000, the median firm had sales between £500,000 and £750,000, and 31.5% of respondents had sales of at least £1 million (2). The age of firms is considerably skewed in favour of the more established businesses. Nearly 40% had been in business for over 15 years. This may reflect the focus on Chambers of Commerce members, many of whom are likely to be well established local businesses.

Asked about their most significant concern with existing bank practices, far and away the most important categories were bank charges (24.7%), interest rates (21.9%) and amount of security (20.5%). These represent the three more specific issues raised in Section 2; they are clearly causing small firms considerable worry. At the other extreme, only 2 firms expressed their major concerns as loan duration. This suggests that banks' alleged short-termism is not worrying their small firm clients, although this may be explained by firms' lack of experience with long term funding. Firms will focus on constraints that they can see; lack of experience with a product would suggest ignorance of any constraints implied by the product's absence.

### 3.2 Financing Conditions

We focused on the last occasion that a firm tried to obtain a bank loan (defined as a fixed term loan, new overdraft facility or increased overdraft facility). 50% last requested a loan in 1991, 31.4% in 1990 and 18.6% pre-1990. Very interestingly, 52.5% reported that banks' final decision on the loan request was made at their regional branches/headquarters, and only 45.8% at a local branch. This is consistent with the charge that banks are too centralised for small firms' needs, raising the issue of excessive distance in the small firm/bank relationship. Moreover there is some suggestion of increased centralisation. Our results compare to the much larger survey reported in Binks, Ennew and Reed (1988). It found that 29.9% of decisions were made at the regional branch/headquarters level and 60.6% at local branches (3).

There appears to be a bias towards shorter term finance, 74.6% of respondents citing requests for either new or increased overdraft facilities. The preference for

overdraft facilities explains why 63.6% said that the payback period for an approved loan was not fixed. Of the 16 firms reporting a fixed payback period 10 had medium to long term loans, those of five years or above. Thus only 22.7% of firms had medium or long term loans approved. Whether this is a result of banks' short-termism is unclear from this evidence. It could be that small firms, banks or both are exhibiting short termist preferences. In addition, the bias towards overdrafts may be explained by the purpose of the loans; 62.7% required working capital and only 27.1% were financing fixed assets. This may reflect the presence of a short run problem, a recession, requiring a short run solution. Another possibility could be that, because of the high real interest rates at the time, investment in longer term assets was being postponed.

Over 84% of loan requests were approved by banks, although among these 8.5% were approved only after further negotiation and 6.8% were rejected by the firms themselves. Only 10.2% of requests were turned down by banks. This indicates that some form of finance is readily available to small firms but that initial loan conditions may be unsatisfactory for a significant minority. Of approved loans, 30.4% (of 46 respondents) reported that they were for amounts of over £100,000. Nearly two-thirds of approved loans were for amounts exceeding £20,000. This may reflect the aforementioned skewed distribution in respondents' sales turnover.

### Interest Rates

The responses to questions on interest rates are interesting and of relevance to the current debate. 86% of respondents were paying less than 3% above base rates, with the most common interest charge being at least 2% but less than 3% above base. This appears to be in line with the recent report from Treasury and Bank of England officials to Norman Lamont (see Financial Times, 18th July 1991). Moreover the comparison with Binks, Ennew and Reed (1988) suggests a distinct downward shift in nominal percentages above base since 1987 (Table 1).

This evidence tends to endorse the banks' position in recent debates. It also suggests that many respondents identifying interest rates as their most significant concern with existing bank practices may really be objecting to government macroeconomic policy, i.e. too high base rates, rather than bank overcharging.

Having said this, 19 respondents were paying a different percentage over base on their most recent loan compared to their second most recent loan, and of these 11 were paying more. This presumably causes concern to some firms, at least.

### Security Requirements

More than one in five respondents cited security as their major concern. To explore this issue, we have looked at

the type of security required by banks and at security ratios. No security was required in 29.8% of cases but some degree of personal security was required in 34% of cases. This is presumably a source of worry (although not necessarily a criticism of banks). Perhaps more interestingly, however, are the responses on security ratios. Nearly 60% of respondents had been required to provide security of at least 2 times the amount of loan, only 6.3% a ratio of less than one. This appears to be quite different to Binks, Ennew and Reed(1988), where 20% seem to have had a ratio of at least 2 and over 60% a ratio of less than one. What appears to be happening is that banks are taking a lower percentage above base, but are cutting off relatively riskier investments by demanding higher security. From a bank's point of view, with a depressed economy and increasing business failure, the move to higher security is logical. However, such high and apparently increasing ratios are consistent with excessive and perhaps growing distance in the relationship between small firms and their banks; recall the argument that security requirements can be so high that a bank sees no need to understand a firm. How can a bank justify a ratio of at least 2 on any new loan?

#### **Further Responses Concerning Distance**

Various questions in the survey shed further light on the distance between small firms and banks. 83.3% said that their bank did not require managerial/operational changes in the business as a condition of the loan. Arguably, an economy in which banks and firms are in a close partnership would be one where funding precipitated useful change, although it would be wrong to read too much into this response. Likewise, 86.7% reported that banks offered no alternative way of fulfilling their loan requirements. This is consistent with a sterile relationship, lacking communication and reluctant to explore fresh possibilities.

From neither of those questions is it possible to apportion responsibility for excessive distance. Question marks over the attitudes of firms, however, are raised by the fact that over 50% took no funding advice outside banks. Only 18.4% took advice beyond accountants.

Similarly, when asked why they chose the method of finance that they did, 18% responded that it was the only source available, 32.8% that it was the cheapest but a further 32.8% that it would avoid outside interference. Moreover a further 6.5% mentioned the avoidance of outside interference as one of several reasons. Although these responses can be interpreted in various ways, they are consistent with the view that firms want to keep their distance from banks.

Section 2 also noted the view that small firms might consider equity as a means of generating a closer relationship with banks. Yet 65.7% reported that they have never considered equity as a source of long term funding, and when asked if they would object to their banks holding equity stakes, 58.8% said that they would.

The main reason was the desire to keep control, cited by 32.4% of respondents. Closely related to this, a further 26.5% wanted to avoid interference.

#### **Long Term Finance**

One major concern much discussed in the literature is banks' short-termism. With this in mind, it is interesting to note that 55.6% reported that their banks have a loan withdrawal clause in their lending contracts. This may be a simple safeguard, but it arguably symptomises a lack of long run commitment.

However, as with the distance argument, it could be that any short-termism is at least in part the responsibility of firms. We have already raised the possibility of firms preferring short term finance. Other responses are consistent with this view. It is quite startling that 47.1% of respondents had not even considered long term funding, an observation underlined by the 65.7% negative response to the equity funding question. This evidence clearly suggests that there is a problem of short-termism but that it characterises small firms at least as much as banks. Indeed, in banks' favour, of the small firms that have considered long term funding, 87.2% said that it is available (although not necessarily from banks).

#### **Charges**

The questionnaire did not explore bank charges, other than interest rates, in detail. Nevertheless, those firms accepting a loan were asked if the original conditions of the loan had changed during the term of the loan, and the responses are fairly interesting. The majority (76.5%) reported no change. Fees were the most common alteration, reported by 11.8%. This is consistent with the concern over bank charges.

#### **3.3 Competition**

Several questions focused on bank competition. Firms were asked if they had noticed a change in competition for their business from banks over the last three years. Of the respondents finding the question applicable, 52.2% had seen no change, 9% a fall in competition and 38.8% an increase. Thus on balance, small firms seem to have seen an increase in competition. However the results are broadly in line with the Binks, Ennew and Reed (1988) study and it concluded that bank competition was more superficial than real.

38.4% of respondents have actively shopped for a different bank in the last three years, compared with approximately 22% in Binks, Ennew and Reed (1988). It is not clear what this rise means. One view is that firms perceive more to gain from shopping around because of greater bank competition. Another is that small firms are increasingly dissatisfied with their banks' performance and that this has pushed them to look for something better. Of the firms that have not shopped around, the most common explanation is satisfaction with

existing banks (53.2%). A significant number (17%) felt that banks are all the same, and a further 10.6% had never considered looking for another bank. All other explanations recorded under 10%.

### 3.4 Bank Services

Small firms were asked about the importance they attach to eight different bank characteristics. The results are summarised in Table 2, focusing on the polar responses for each characteristic.

Great care is needed to avoid reading too much into such a descriptive presentation as this. Nevertheless it raises some interesting issues. The proportion of respondents rating banks as good or fairly good for a characteristic is often largely in line with the proportion rating the characteristic as very important. Similarly the poor/fairly poor rating is often broadly in line with the not important proportion. The most notable exception to this is over the range of banks' services, where the evidence is consistent with banks offering a wider range than their clients desire. Moreover other characteristics are also interesting, not least banks' knowledge of firms and their businesses. Virtually 70% rated the characteristic as very important but only 50% saw banks' performance as good/fairly good. This is evidence in favour of excessive distance in the small firm/Scottish clearing bank relationship.

Bearing this in mind, it is interesting to delve slightly deeper into the two other knowledge characteristics that we examined. One of the most striking things is the low importance that firms attach to both industrial knowledge and knowledge of the local market; in both cases 43.8% of firms feel that the characteristic is unimportant. Arguably, this again raises the point that excessive distance in the bank/small firm relationship is a two-sided issue; both banks and small firms are responsible. Moreover, if distance is a problem, it is disturbing that things appear to be worsening. In Binks, Ennew and Reed (1988) 25.2% rated industrial knowledge as very important (compared to our 16.4%) and 33.7% as not important (compared to our 43.8%); similarly, 13% rated banks relatively well in their performance re industrial knowledge and 37.3% relatively badly (compared to our 10.6% and 57.5%). Likewise, in Binks, Ennew and Reed (1988) 23.9% rated local knowledge (4) as very important (compared to our 19.2%) and 40.1% as not important (compared to our 43.8%); 24.7% rated banks relatively well in their performance re local knowledge and 18.6% badly (compared to our 16.9% and 33.8%). Running against this apparent trend, however, our questionnaire also considered changes in characteristics over the last three years. Asked about local knowledge 84.3% said that there had been no change.

This question about changes also covered other areas. In all cases the majority reported no change. Improvements were detected in access to managers and services offered. However, of the 25% reporting changes in staff ability,

two-thirds felt that the situation had worsened. Queries over banks' staffing policy are also raised by the observation that 38.9% saw changes in staff continuity, of which nearly three-quarters saw changes for the worse. On the issue of lending criteria, of the 31.9% of firms that had observed changes, the vast majority noted a worsening of conditions.

Finally we asked two more general questions about banks' services. The responses raise more questions than they answer but we feel that they are nonetheless interesting. First, are bank services flexible enough to meet the special needs of small firms? 59.1% said no. Alongside other responses, this suggests that aspects of the relationship between small firms and banks need to be reviewed and revised. Secondly, are banks helpful to firms experiencing financial difficulties? This question focused on problems over the last three years. 37.2% said that their banks had been okay, 41.9% very helpful and 20.9% not helpful.

### 4. CONCLUSIONS

Whilst our survey does not provide the final word on any particular issue, we offer our interpretations of the results as a basis for discussion and further analysis of the small firm/Scottish clearing bank relationship.

Clearly our evidence indicates that interest rates, other bank charges and security levels remain an important worry for small firms. On interest rates it appears that much of the criticism levelled at banks may be misplaced; the underlying issue could be the government policy of high real interest rates. This is supported by our findings that the percentage paid over base on loans has declined since the late 1980's, and is on average at least 2% but less than 3% over base, and that this may have declined since the late 1980's. Our findings on security levels are of greater concern and raise an important question. The average security ratio is at least 2 and appears to have risen; why?

Turning to the three more fundamental characteristics which have been said to characterise the small firm/bank relationship, our evidence on market power is indeterminate. Far more interesting is our evidence on short-termism. Our survey suggests that there is a problem but that it is not simply an inadequate supply of long term capital. Rather, our results are consistent with the view that Scottish banks and small firms should both reconsider their time horizons. Recall, for example, that nearly half of all respondent firms had never even considered long term funding.

Equally interesting is our evidence on distance in the small firm/bank relationship. This is consistent with excessive distance due to the wishes of both banks and small firms. In many ways this is our strongest point. On the one hand, for instance, banks appear to make well under half of their loan decisions at local level. On the other hand, firms put very little store by banks' local and industrial knowledge.

We are left with the suggestion that the relationship between small firms and banks is sterile, uncommunicative and unimaginative, and that both must take responsibility for this situation. There appears to be scope for an all-round reappraisal of positions.

#### NOTES

- (1) This draws on literature considering banks in general, not merely Scottish clearers.
- (2) Unless otherwise stated, figures refer to those firms replying to a specific question. For instance, of the 67 firms replying to the turnover question, 31.5% had sales exceeding £1 million.
- (3) These results are not confined to Scottish clearing banks. The same is true for all comparisons with Binks, Ennew and Reed (1988) throughout the paper.
- (4) Binks, Ennew and Reed (1988) actually refer to "knowledge of local market/community".

**Table 1 Distribution of interest charges**

Our Survey		Binks, Ennew and Reed Survey	
Percentage above base	Percentage of respondents	Percentage above base	Percentage of respondents
0 ≤ <2	34.9	0-2	7
2 ≤ <3	51.2	2-3	38
3 ≤ <4	9.3	3-4	42
4 ≤ <5	0	4-5	11

**Table 2 Importance of bank characteristics**

Characteristic	Importance of Characteristic %		Performance re Characteristic %	
	Very Important	Not Important	Good/Fairly Good	Poor/Fairly Good
Knows you and your business	69.9	8.2	50.0	20.0
Provides business advice	19.2	54.8	11.7	51.5
Offers finance	67.1	8.2	59.4	26.1
Continuity of staff	26.0	15.1	32.4	33.8
Industrial knowledge	16.4	43.8	10.6	57.5
Speed of decision/service	47.9	6.8	55.1	15.9
Wide range of services	15.1	37.0	50.7	19.4
Knowledge of local market	19.2	43.8	16.9	33.8

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