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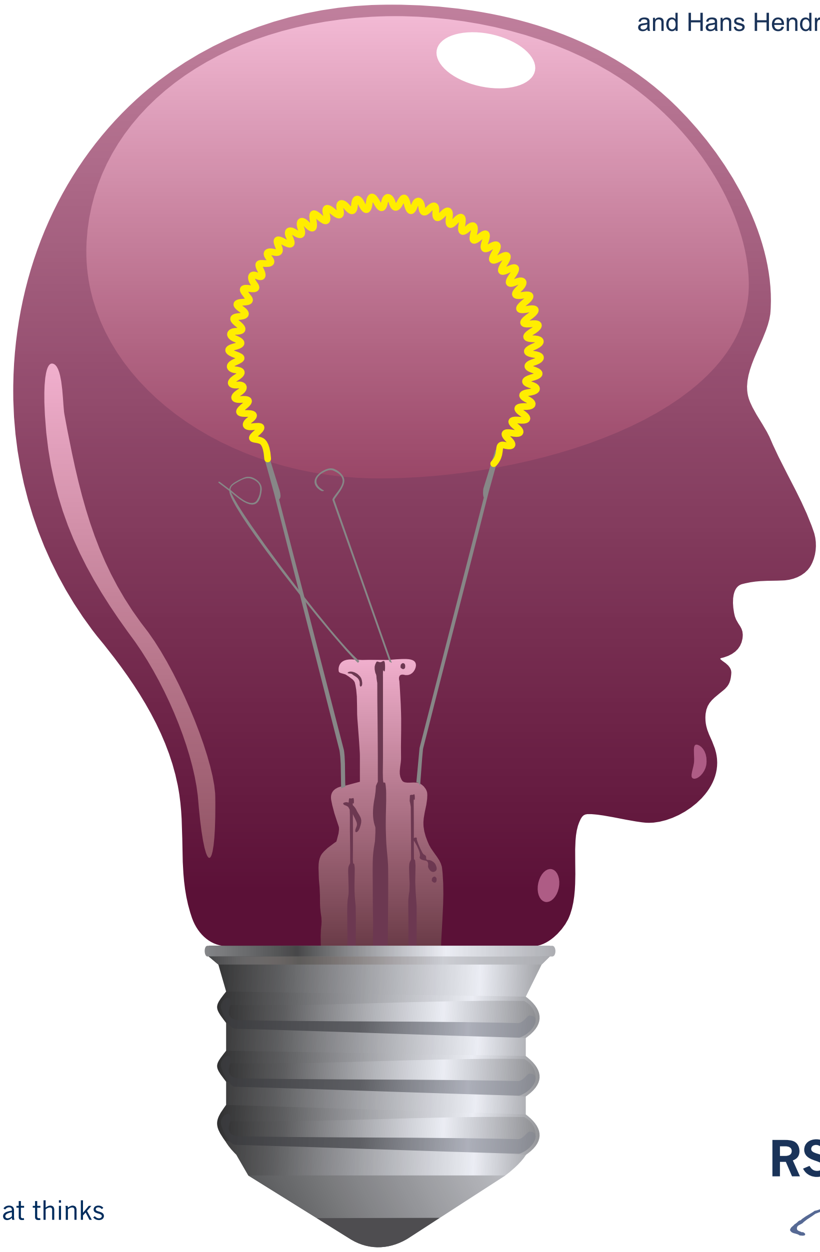

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Soft information matters in SME lending

by Jens Grunert & Lars Norden

Loan data from small and medium-sized enterprises (SMEs) has shown that such positive attributes as good management skills and character – so-called 'soft' facts – can improve a borrower's bargaining power with their bank and thus loan terms.

Small and medium-sized enterprises (SMEs) in the United States of America and many European countries are limited in the ways they can finance their operations. While larger enterprises have access to capital markets for their funding, SMEs have to rely heavily on banks for their borrowing needs. This is because SMEs, unlike their larger counterparts, are not covered by the large credit rating agencies and do not have to publish quarterly or annual financial statements. And with few or no 'hard' facts available, SMEs are viewed by banks as being informationally opaque and difficult to evaluate financially. Consequently, these financial institutions have to resort to *qualitative* information ('soft' facts) about an SME and its manager or owner to assess creditworthiness.

Through our recent research, we have sought to determine if there is a relationship between the quality of the available information (mainly 'soft' facts) banks have on their SME borrowers and the resulting bargaining power of these borrowers. Our research was based on a representative sample of SME loan data from both the USA and Germany.

Credit information

Let us first define what we mean by 'hard' and 'soft' information or facts in the context of bank relationships. Hard information refers to the usual quantitative details found in financial statements, such as sales, profit, cash flows and leverage. Soft information, as the term suggests, is more qualitative and refers to such intangibles as management skills, company strategy and market share. It also includes the credibility and reliability of the company director or owner. It has been known in banking circles for a very long time that the character of a borrower plays an important role in deciding on a loan.

It is not only a question of whether borrowers are able of repay a loan; it is whether they feel duty-bound to do so. In fact, the American banker's handbook goes as far as to say that "there is no substitute for character - it is a vital factor".

Another important soft fact has to do with continuity and governance, especially important in privately owned family businesses, which SMEs tend to be. What happens, for example, if the current manager or owner dies? Is there an established line of succession in place to ensure business continuity and good governance?

While hard and soft information is important in assessing the creditworthiness of all firms, soft information is particularly important for SMEs, due to the absence or unreliability of hard facts, and the reason why banks place significantly more weight on it. Crucially, a good assessment based on soft information means that borrowers could get a better deal on their loan.

As part of our study we analysed SMEs in the United States and Germany with the *same* credit rating to see whether some of them had better bargaining power. Bargaining power is determined by examining loan contracts in a particular credit-rating category for the interest rate charged and the collateral pledged, and then comparing them against the average interest rate and average collateral requirement respectively within that category. Firms that managed to negotiate a below-average interest rate and a below-average collateral requirement have bargaining power

in our investigation. We then look to see if these two measures of bargaining power are related to a good hard- and soft-facts assessment. We are able to extract this information from the banks' credit-rating assessment details.

Bargaining power

Our results are quite revealing and have consequences for entrepreneurs, SMEs and banks. We find evidence to support the hypothesis that bargaining power is directly related to good soft facts. What is more, we can show that soft information has not only first-order effects on the credit rating of the borrowing firms, but also second-order effects on borrower bargaining power. This of course is excellent news for entrepreneurs and SMEs. After all, with the exception of the credit offered by their suppliers, SMEs rely mainly on banks for external funding and this can reduce their loan costs significantly.

However, SMEs have to ensure that banks are fully aware of this soft information; something savvy managers with good communicating and negotiating skills are capable of doing. This may require SMEs to invest in this capability. We also find that entrepreneurs with a good educational background tend to have more sophisticated communication skills, and are consequently more proficient at negotiating with their banks and in using their soft facts to their advantage.

Our study also has implications for banks. Considering bargaining power and soft information relate to the strength of the bank–borrower relationship, loan officer turnover is recommended as an effective device to maintain incentives inside the bank and to avoid collusion between loan officers and borrowers. Furthermore, since the evaluation of soft information depends, among other factors, on the loan officer's experience with the borrower, it could be reasonable to assume that new loan officers tend to make an 'average assessment' in order to trade-off the risk assessment and lending volume. Consequently, loan officer rotation helps to avoid a systematic drift towards increasing borrower bargaining power over time, arising either from gradually increasing accuracy of the loan officer's assessment, or from collusion.

"The character of a borrower plays an important role in deciding on a loan."

A related implication is that loan officers might have to personally bear the negative consequences arising from high borrower bargaining power. If they were paid according to the contracted loan rate margins, however, lower spreads would reduce their variable compensation. Finally, there is the question of bank competition. For example, the number and structure of bank relationships as well as switching costs of borrowers might relate to the interaction between bargaining power and soft information in banking.

To summarise the key findings, our study suggests that soft information represents an important and direct determinant of borrower bargaining power, with strong implications for banks and SMEs in the way they operate in the loan contracting process. ■

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