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Soft information matters in SME lending

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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
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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