BANKING IN THE ERA OF GLOBALIZATION: WHY BANKERS SHOULD FOCUS ON 'RELATIONSHIP BANKING' WITH THEIR SMALL BUSINESS CUSTOMERS?

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ABSTRACT

The growing financial sophistication of customers, the greater and more efficient use of information technology and the increased types of institutions offering similar products and services in the market place have intensified competition in the banking industry in Malaysia. This competitive environment makes it a necessity for banks to focus more on establishing and maintaining relationships with customers. One important segment, the small business sector, however had not been given much attention by the banks. The small business sector is now a significant contributor to the country's economy, and the banks may miss the opportunity of an emerging lucrative market if they fail to recognize the potential profitability that this sector provides. This paper reports on a study conducted among the small business owners in the relationships with their banks. The findings will provide banks with information on understanding the needs of the small business customers they serve or want to serve.

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1.0 INTRODUCTION

Forces of globalization fuelled by advances in information technology and the growing financial sophistication of customers have changed the banking environment during the last decade. This has resulted in intensified competition among the existing and new players in the market place. The key to success or even surviving in an increasingly competitive environment requires an increasingly deeper understanding by banks of this environment and to capitalize on opportunities associated with it. Banks are now finding themselves in the situation whereby they are having to work harder to retain customers that they once had the luxury of taking for granted. One of the strategies is for the banks to establish and maintain strong relationships with their customers. Seybold (2001) argues that building deep relationship with customers is vital to ensure the maintenance of future earnings. Banks need more effective approach to an understanding of customers and their needs. However, one increasingly important segment of the market, which arguably has not been given enough attention, is the small business sector. The small business sector is now a significant and growing market segment and its importance to the economic development of a nation is well established. The banks may miss the opportunity of an emerging lucrative market if they fail to recognize the potential profitability that this sector provides. Studies by Kolari, Berney & Oui (1997) and Dunkelberg (1997) revealed that, on average, banks earn higher profit margin on small business loans than on other assets. Furthermore, if banks focus mainly on large customers, this could lead to smaller margins. These customers have a readily available source of funding through the capital market, and hence the additional negotiating advantage. As a result, large business customers may no longer provide the profit potential they once did. Therefore, the ability to attract and retain small business customers should be in the long-term interest of the bank.

This paper reports on a study conducted among small business owners on their business relationships with the banks. The purpose is to generate an understanding of the nature of bank-small business customer relationships in Malaysia. The findings of the study will provide banks with information that may put them in a better position to understand the needs of their small business customers.

2.0 LITERATURE REVIEW

2.1 What is a small business?

There is no commonly held definition of what constitutes a small business. A business may be regarded as 'small' if it has certain economic or management characteristics. For example, Watson & Everett (1993) define it as a business in which one or two persons are required to make all the critical management decisions in finance, accounting, personnel, purchasing, processing, servicing, marketing or selling without the aid of internal specialists and with specific knowledge in only one or two functional areas. Storey (1982) categorizes a small business as that of having a small market, being managed by the owners who are legally independent in taking their decisions. In Malaysia, various criteria have been used to classify the business for the purpose of allocating technical or financial assistance. The Small and Medium Industries Development Corporation (SMIDEC), an agency under the Ministry of International Trade and Industry (MITI) defines it as a manufacturing enterprise with an annual sales turnover of not exceeding RM25 million or as a business enterprise which employs up to 150 full-time workers (Smidec, 2002). The World Bank study on Malaysian industries considers the small business enterprises as those employing between 5 to 49 full-time employees, and the medium-sized enterprises as having between 50 to 199 employees (UNIDO, 1990).

For the purpose of this study, the term 'small business' is used to indicate the small and medium sized enterprises (SMEs) or industries (SMIs) as defined by the Central Bank of Malaysia. Under this definition, SMEs or SMIs are those registered businesses with net assets of up to RM2.5 million or in the case of limited companies, with shareholders' funds of not more than RM2.5 million. Definition by the Central Bank is strictly observed in all commercial bank lending in Malaysia. The small business sector, therefore, refers to all businesses that fulfill the above definition. A great majority of these businesses are independently owned and operated by individuals and families.

2.2 What is relationship banking?

The acceptance and application of relationship banking have grown in the banking sector where an emphasis is being placed on the management of customer relationships (Barnes & Howlett, 1998; Dibb & Meadows, 2001). According to Moriarty, Kimball & Guy (1983), relationship banking is a recognition that a bank can increase its earnings by maximizing the profitability of the total customer relationship over time, rather than by seeking to extract the most profit from any one individual product or transaction. Because most banking customers purchase many products and services, and do so on recurring basis, the bank must build and maintain a number of product or service relationships to reach the full potential of the customer. Relationship banking emphasizes deeper penetration of the existing customer base. Main (1982) argues that in relationship banking, the customer gets to deal with a real human being, preferably one who is knowledgeable and courteous and who will get to know his name. What the customer seems to want more than anything else is a sense of importance, like being recognized by a head waiter. Levitt (1983) says that the relationship between a seller and a buyer seldom ends when a sale is made. Increasingly, the relationship intensifies after the sale and helps determine the buyer's choice the next time around. In banking, becoming the designated supplier requires successful passage through several consecutive gates or stages in the sales process.

Relationship banking can also be seen as the bank's relationship with the customer that is not confined to contact when a credit limit is exceeded, or a new application made for a loan, but which is renewed on a regular basis so that the banker builds up a real understanding of the firm's progress and financial needs (Read, 1998). The underlying principle behind relationship banking is that banks can enhance customer satisfaction and in so doing can enhance their own performance. For such benefits to accrue, relationships must be developed and managed to the customer's satisfaction.

2.3 Bank-small business relationships

Past studies have documented the problematic relationships between banks and their small business customers. Wynant & Hatch (1990) argue that banks did not have sufficient knowledge or understanding of how small businesses operate and of what their needs are. Clay & Cowling (1996) reveal that lending decisions on small businesses were not based on actual prospects of the business but instead on the likelihood of the banks being collateralized and secured. Banks were seemed much more concerned with how a long would be repaid if the business failed rather than the prospects for success and greater involvement with the small business customers (Lambden & Targett, 1993). However, Wynant & Hatch (1990) assert that banks are in the business of providing low risk financing to small businesses, and sometimes, may find that the purposes sought by the small business owners are not necessarily appropriate for bank financing.

The significant cause of conflict in the bank-small business relationship is the asymmetry of information between the two parties, that is, the small business owner is generally more informed on the financial circumstances and prospects of the business than the bank (Storey, 1994). This situation can give rise to a twin problem of moral hazard and adverse selection. In the former situation, the issue arises where the action of a small business borrower is not directly observable by the banker once he obtains the loan. This borrower may use the borrowed funds for other purposes that may be detrimental to the bank. An adverse selection occurs because the banker cannot distinguish the good risk and the bad risk borrowers (Cowling & Sugden, 1995). A small business owner when approaching the bank for loan has always an advantage over the banker which leads him to overstate the soundness of the business in relation to the funding sought. This explains why some small business ventures, which have high potential for growth and profitability are sometimes turned away by the banks.

The concept of relationship banking has been advocated by some researchers as an effective strategy to overcome the problems in the bank-small business relationships (Madill, Feeney, Riding & Haines, 2002; Blackwell & Winters, 1998; Cole, 1998; Berger & Udell, 1995). It is argued that banks can gain information on their customers over the course of their relationships and then use this information to help in making lending decisions. Information may be gathered over time through a series of loans extended to the small borrower, and the provision and delivery of other financial services. Conditional on this experience, the bank may expect the loans to be less risky, and as a consequence, reduces the interest charged. The customer may not only benefit in terms of lower cost but also in greater access to bank funds due to efficient gathering of information (Berger & Udell, 1998).

Peterson & Rajan (1994) examined the relationship between a small firm and its creditors and how it affects the availability and cost of funds. They found that the length of relationship has a positive and significant effect on the availability of credit to small firms. Likewise, Black & Winters (1997) found a positive relationship between a bank's monitoring effort and the interest rates. Banks would monitor less frequently customers with whom they have closer relationship and ultimately charge them lower interest rates. Bank is also more likely to extend credit or loan to a customer which it has a pre-existing relationship as a source of financial service (Cole, 1998).

The relevance of a borrower's credit in the relationship is also emphasized. The longer the borrower repays his loans, the more likely the business is considered viable, and his trustworthiness. This leads to a building of a good reputation, an increase in the availability of funds, and a relatively lower rate of interest charged on loans. On the other hand, borrowers who default in loan repayments may be denied credit thereafter. Consequently, this leads to an improvement in the quality of small borrowers, and the lowering of lending rates.

The benefits of a good relationship between banks and small business are considerable. From the bank's perspective, as it becomes more knowledgeable about the small business, it will improve its ability to retain the business. This include the potential profit of that business as the customer grows and positive promotion among the small business community. From the small business's perspective, if it can develop closer and stronger bonds with its bank, then it is more assured of financial support even in times of difficulty.

Given the importance of good bank-small business relationships, and given the problems experienced by the two parties, the issue in the Malaysian context is worth exploring further.

3.0 METHODOLOGY

The sampling method used in this study was a simple random sample. A total of 150 questionnaires were distributed to the small business owners in the northern region of peninsular Malaysia. However, achieving a representative sample of small business owners in Malaysia is problematic, since appropriate sampling frames do not exist. The questionnaires were handed personally to the owners either in the offices or business premises, and a significant number of questionnaires were left for subsequent completion. The respondents were then asked to return the questionnaire in the self-addressed enveloped provided. A total of 64 useable questionnaires were received, representing a 42.6 percent return rate.

The questionnaire consisted of two parts. The first part included the demographic characteristics of the respondents such as gender, age, years of business, number of employees and types of business ownership. The second part was related to the small business owners' interaction and relationship with the banks. The questionnaire had open questions, classification questions, preference questions and attitude questions. Because of the exploratory nature of the study and the nature of the sample, formal statistical tests were not used. The data analysis is based on frequency distributions and cross-tabulations. Some of the questions could be answered by 'yes' or 'no', and other questions respondents were asked to rate with various indicators, using a 3 point scale from '1' for a poor evaluation to '3' for a good response. Owing to the fact that, a large number of those who responded have 15 or less number of employees, the findings of this study will reflect the views of mainly the micro or smaller business segment of the small businesses in Malaysia.

4.0 FINDINGS AND DISCUSSION

4.1 Characteristics

The profile of respondents and business characteristics are outlined in Table I below.

Table I

1.Gender	Frequency	Percentage
Male Female Total	40 24 64	62.5 37.5 100.0
2. Age (years)		
Below 30 30 – 40 41 – 50 Above 50	9 20 22 13 64	14.1 31.3 34.4 20.3 100.0
3.Business ownership		
Sole proprietorship Partnership Limited companies	33 15 16 64	51.6 23.4 25.0 100.0
4. Age of business (yrs)		
Less than 5 5 – 10 11 – 15 16 –20 More than 20	18 18 13 9 6 64	28.1 28.1 20.3 14.1 9.4 100.0
5. No. of employees		
Less than 5 5 – 10 11 – 15 More than 15	42 15 4 3 64	65.6 23.4 6.3 4.7 100.0

Most of the respondents ranged in age from above 40 years with 54.7 percent, between 30 to 40 years with 31.2 percent and below 30 years with 14.1 percent. This shows that the small business owners in this study were of middle age group. In terms of gender, only 37.5 percent of the respondents were female. All the three types of business ownership were represented with the largest number of respondents came from sole-proprietorship (51.6 %), followed by limited companies (25.0 %) and partnership (23.4 %). 65.6 percent of the respondents reported an employee level of less than 5, another 23.4 percent had an employee level of between 5 and 10, and only 4.7 percent had more than 15 employees. About 28.1 percent of the respondents had been in business for less than 5 years, another 48.4 percent ranged from 5 to 15 years, and only 23.5 percent had been running the business for more than 15 years.

4.2 Satisfaction in banking relationship

The respondents were asked to rate their levels of satisfaction on the overall relationship with the banks, the relationships with the bank personnel and the quality of services provided by the banks. Table II below shows that the majority of respondents (70.3%) rated 'good' and above in their overall relationship with the bank. 17.2 of them gave a 'very good' rating. Only 2 respondents or 3.1 percent felt that their banking relationship was poor. However, none gave a 'very poor' rating. On their relationship with the bank personnel, the respondents gave an even higher rating of 'good' and above (73.4%), and only 1.6 percent with a 'poor' rating. The unexpectedly high ratings given by the small business owners to the overall banking relationship contrasted those found in most literature where small business owners, generally, had problematic relationships with their bank.

Table II: Relationship with the bank

Levels of satisfaction	Frequency	Percentage
Very good	11	17.2
Good	34	53.1
Average	17	26.6
Poor	2	3.1
Very poor	0	0
	64	100.0

Table III: Relationship with the bank personnel

Levels of satisfaction	Frequency	Percentage
Very good	8	12.5
Good	39	60.9
Average	16	25.0
Poor	1	1.6
Very poor	0	0
	64	100.0

Respondents were also asked how they would rate the overall quality of service which they receive from their bank. Table IV below shows 12.5 percent of the respondents replied 'very good', 53.1 percent gave 'good' rating and 6.3 percent believed the quality of service to be poor.

Table IV: Quality of services provided by bank

Levels of satisfaction	Frequency	Percentage
Very good	8	12.5
Good	34	53.1
Average	18	28.1
Poor	4	6.3
Very poor	0	0
	64	100.0

4.3 Important elements in the banking relationship

The respondents were also asked to rate the importance of ten factors in relation to a good banking relationship. The results presented in Table V below show that there was a strong agreement among the respondents with regard to the importance of cost factor and elements of bank service of the banking relationship. Over 68 percent of respondents rated the factor 'bank offers best terms and rates, 64.1 percent rated 'bank handles credit request quickly' and another 59.4 percent of respondents rated 'bank offers a wide range of services' as being 'very important' for a good banking relationship. Surprisingly, a significant percentage of respondents believe that the interpersonal elements of the banking relationship were not of being importance. "Bank manager treats me with respect' (17.2%), 'bank manager makes me feel comfortable'(14.1%), 'bank manager is easy to talk to' (12.5%), and 'bank has specialized personnel'(10.9%) were some of the factors rated as 'not importance'.

Table V

Factor	VI	%	I	%	NI	%
1. Bank knows me and my business	36	56.3	25	39.1	3	4.7
2. Bank provides helpful business advice	32	50.0	27	42.2	5	7.8
3. Bank offers best terms and rates	44	68.8	19	29.7	1	1.6
4. Bank offers a wide range of service	38	59.4	24	37.5	2	3.1
5. Bank handles credit request quickly	41	64.1	21	32.8	2	3.1
6. Banker is easily accessible	34	53.1	29	45.3	1	1.6
7. Bank has specialized personnel	23	35.9	34	53.1	7	10.9
8. Bank manager is easy to talk to	29	45.3	27	42.2	8	12.5
9. Bank manager makes me feel comfortable	27	42.2	28	43.8	9	14.1
10. Bank manager treats me with respect	26	40.6	27	42.2	11	17.2

VI – Very important I – Important NI – Not important

The respondents were then asked to rate their bank's performance on the same ten factors of good banking relationship.

Table VI

No.	Factor	GD	%	AC	%	UN	%
1.	Bank knows me and my business	37	57.8	25	39.1	2	3.1
2.	Bank provides helpful business advice	29	45.3	24	37.5	11	17.2
3.	Bank offers best terms and rates	33	51.6	28	43.8	3	4.7
4.	Bank offers a wide range of service	41	64.1	22	34.4	1	1.6
5.	Bank handles credit request quickly	35	54.7	26	40.6	3	4.7
6.	Banker is easily accessible	36	56.2	25	39.1	3	4.7
7.	Bank has specialized personnel	22	34.4	34	53.1	8	12.5
8.	Bank manager is easy to talk to	30	46.9	27	42.2	7	10.9
9.	Bank manager makes me feel comfortable	32	50.0	27	42.2	5	7.8
10.	Bank manager treats me with respect	34	53.2	25	39.1	5	7.8

GD – Good, AC – Acceptable, UN - Unsatisfactory

Table VII below analyses the respondent's satisfaction with the banking relationship in terms of 'scores' awarded to each factor by each respondent. The banks are found to score well on 'wide range of service', followed by 'knows me and my business', and 'easily accessible'. However, the banks performed less well on 'specialized personnel' and 'helpful business advice'.

Table VII

Bank performance scores

Factor	Total	Average
1. Bank knows me and my business	35	0.54
2. Bank provides helpful business advice	18	0.28
3. Bank offers best terms and rates	30	0.46
4. Bank offers a wide range of service	40	0.62
5. Bank handles credit request quickly	32	0.50
6. Banker is easily accessible	33	0.51
7. Bank has specialized personnel	14	0.21
8. Bank manager is easy to talk to	23	0.35
9. Bank manager makes me feel comfortable	27	0.42
10. Bank manager treats me with respect	29	0.45

4.4 Problems in the banking relationship

The respondents were also asked on the problems they encountered in their banking relationship. Table VIII below shows that the most frequently cited bank related problems were the slow and poor counter service, unhelpful attitude of bank staff, difficulties in getting access to bank loans, high charges for loans and advances, and no 24 hours or ATM services.

Table VIII

	Problem	Frequencies	Percentage
1.	Slow and poor counter service	29	45.30
2.	Unhelpful attitude	16	25.00
3.	Difficulty in obtaining loan	12	18.75
4.	High interest charges	7	10.93
5.	No 24 hours or ATM service	7	10.93

Slow and poor counter service was a major source of problem in the banking relationship, and was mentioned by 45 percent of the respondents. The main complain were that there were often long queues at the counters, insufficient staff to handle the customers, and the longer time taken to handle cases. The second main problem cited was the perceived unhelpful and unfriendly attitudes shown by the bank staff. The complaints were that of staff complacency and arrogance when dealing with customers. These bank staffs were not seemed to be interested in giving customer satisfaction. There was also a feeling among some of the respondents that bankers did not understand them, the needs and the problems of their business. These bankers did not show their interest when approached for loans. Therefore, they faced difficulties in getting access to bank loans. Some of the respondents who obtained advances and loans felt that the charges were too high and the terms and conditions imposed on them were unfavourable.

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