AGENCY RELATIONSHIP PROBLEMS AND LENDING TO SMALL BUSINESSES

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SMALL BUSINESSES RELY heavily on bank loans for their financial needs. However, banks encounter risks when considering loans to these businesses. Many of these risks are attributed to the agency problems in their relationships. It is also argued that the agency problems are likely to be most significant when the business is small. Sometimes these problems affect the willingness of some banks to provide funds to the small business sector. This paper highlights the agency problems between commercial banks and small businesses, the use of several loans features to overcome these problems, and to suggest alternatives to increase the accessibility of bank funding to the small business sector.

AGENCY RELATIONSHIP

The agency theory focuses on the relationship under which one or more persons (principals) engage another person (agent) to perform some services on their behalf. This contract involves delegating some decision-making authority to the agent. In the case of a small business, the agent is typically the owner while the principal is the supplier of external funds, notably a bank. This separation of ownership and control may result in a problematic relationship because there is always a possibility that the agent may not act in the best interest of the principal but instead acts in his self-interest. The small business has considerable operational flexibility that makes it easier to transfer assets to other uses in response to a changing business environment, and this can have an adverse effect on the bank (Pettit & Singer, 1985).

The first problem that arises from the agency relationship is the asymmetry of information. This problem, sometimes referred to as 'hidden knowledge or information', occurs when one party to a transaction knows relevant information which has a material effect on the transaction, but which is not known to the other party (Binks et al, 1992; Amit et al, 1998). The small business owners when approaching banks for loans always have an informational advantage over the bankers, that sometimes lead them to overstate the soundness of their business projects in relation to the funding sought (Storey, 1994). This problem can impede the flow of funds to the small business sector because banks may choose to ration the amount of loans they grant or extend credit only on relatively unfavourable terms (Stiglitz and Weiss, 1981).

The second problem in an agency relationship is the moral hazard, often described as 'hidden action'. It is a situation where an agent does not act in a manner consistent with the contract with the principal, or in the principal's best interest (Guesnerie et al, 1988). The issue of moral hazard was first discussed in the insurance market where the insured parties could take actions that either increase or decrease the risk of hazard. For example, after purchasing a motor insurance, the insured party could either drive safely or dangerously. Arrow (1973) and Pauly (1979) who conducted earlier works on moral hazard found that it could also cause market failure. In lending to a small business, the problem of moral hazard arises where the action of the owner who successfully obtained a bank loan is not directly observable by the banker. The borrower might use the funds for other purposes than stipulated in the contract, sometimes out of self-interest, and such actions may incur high costs on the part of the banker (Heffernan, 1996).

The asymmetry of information can give rise to a third problem, namely, adverse selection which causes inefficient allocation in the market. In this situation, the market may be crowded with 'low quality' projects, simply because it is hard for

lenders to distinguish between good and bad quality projects. They have to make decisions based on their knowledge of the borrowers' skills and competencies. The adverse selection occurs in small business lending because bankers cannot distinguish between the two types of borrowers, the good risk and bad risk. A bad risk borrower has an incentive to pretend to be a good borrower, and thus benefits from more favourable lending conditions. To prevent this problem, the bank may raise the collateral required from the good borrower, thus removing the incentive for the bad borrower to default. However, by doing so the bank also imposes an unfair cost on the good borrower.

Agency problems have contributed significantly to higher costs in lending to small businesses. These include the costs of monitoring and bonding. Monitoring costs occur because the activities of the agent (borrower) must be monitored to ensure that he conforms to the contract. Bonding costs are incurred by the agent to guarantee that he will not take certain actions that would harm the principal (banker), and to ensure that the principal is compensated if the agent does take such actions. Therefore, the banker will require a greater level of compensation and protection to cover the risks and overcome the problems of asymmetric information, such as charging higher interest rates on the borrowers.

OVERCOMING THE AGENCY PROBLEMS

Banks face difficulties in overcoming the problem of moral hazard because it is not economical to devote resources to appraisal and monitoring where the loans are relatively small. When making lending decisions on small businesses, banks also make errors because of adverse selection. As a result, banks sometimes turn down a business or project which turns out to be a success, or they may lend to a project which turns out to be a failure.

In overcoming agency problems, banks resort to various protective measures. They usually require a greater level of compensation and protection to cover the risks, such as charging higher interest rates, asking for higher collateral requirements, and/or imposing some conditional features in the loan contract. However, adjusting interest rates does not necessarily reduce the problem of adverse selection or moral hazard. On the contrary, it influences the riskiness of the average borrowers as well as the demand for funds. Higher interest rates attract riskier borrowers (ie, an adverse selection problem) and induces borrowers receiving loans to alter their behaviours to adopt more risky projects (ie, a moral hazard problem). Hence, banks may address the problems by restricting the amount of lending rather than increasing interest rates.

Alternatively, some conditions may be imposed in a loan contract to help resolve the adverse selection and moral hazard problems, and the most common is the collateral requirement. Collateral can be used to signal commitment on the part of the owner to the success of his business or project. It can either be the pledging of assets owned by the firm or the pledging of assets owned outside the firm, typically assets belonging to the firm's owners. The former reorders the claims of the firm's creditors by giving one of them priority through a security interest in specific assets. The latter enhances the claim of a single creditor by conveying recourse against additional assets outside the firm, without diminishing the claims of the other creditors in the event of bankruptcy. Collateral reduces the moral hazard problem because the owner is unlikely to switch to a riskier project or to reduce effort unless he is willing to lose the collateral (Boot et al, 1991). The level of collateral that a small business borrower is willing to provide helps improve his incentives, and certainly influences the lending decision

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Loan covenant is another feature that a banker can include in the contract. A covenant will limit the actions of the business owner (ie, the borrower). It is intended to give the banker more control and prevent the borrower from engaging in activities against the banker's interest. The borrower must first obtain permission from his banker

before embarking on any significant strategic changes, such as changing his financial condition or strategy, or shareholding. Studies by Rajan and Winton (1995), Berlin and Mester (1992) and Park (1994) show that giving banks the right to renegotiate or call loans when covenants are violated enhances the efficiency of the loan contracts. It also gives more flexibility and control on the loan contract. Firms with the most credit risk and greatest moral hazard incentives are also found to be bound with the strictest covenants.

However, little is known on the use of covenants on small business loans, although there is some empirical evidence to suggest their uses in lending to larger firms. In addition, effective covenants generally cannot be imposed on small firms which do not have credibly-prepared or audited financial records. As an alternative, banks can shorten the maturity of the loans as a means to control the behaviours of small firms. It is believed that the longer the loan contract is, the greater the opportunity for the borrower to alter his risk behaviour. Shortening the loan maturity can also be viewed as a particularly strong type of covenant. With a sequence of short-term loans, a banker can force negotiation frequently, whereas in covenants, renegotiation can only be triggered by those enumerated in the loan contract.

THE MALAYSIAN EXPERIENCE

Is the relationship between banks and small businesses in Malaysia problematic? This issue has long been the focus of debates among various interested parties, especially the authorities, academics, bankers, small business community and the media. It is often argued that small businesses in Malaysia have not been getting their due share of bank funding, and that banks have not been able to take care of their credit needs. A number of studies have confirmed that small businesses had difficulties in gaining access to the banks. Chee (1986) and Hamed (1995) found that most of these businesses finance their operations using their own capital, from relatives and friends or through non-institutional sources (Chee, 1986; Hameed, 1995). The studies also revealed that the proportion of bank loans, if given to small businesses, is much smaller than that for larger firms or that the packages are inflexible to meet their needs. Therefore, when facing financial difficulties, the small business owners seldom or never approach the banks because of their limited experience with bank procedures. Sometimes the experience of some small business owners who had failed to obtain assistance from banks may discourage others from trying to apply for bank loans.

A further study by this writer (Rosli, 2000) also confirmed the problematic relationships between banks and the small business community in Malaysia. The finding revealed a conservative attitude among most of bankers when deciding on lending to small businesses. They took a very cautious approach, especially when dealing with new ventures. A plausible explanation for the attitude of these bankers is that small businesses in Malaysia are also associated with the asymmetry of information. Given this attitude, it is not surprising if these banks were reluctant to finance longer-term loans, where it would incur considerable risk and high monitoring costs.

Banks in Malaysia also operate in an imperfect market where the problems of adverse selection and moral hazard occur. As a result, they are preoccupied with perceived risks when dealing with small business customers. This preoccupation with risks may have contributed to the reluctance of some bankers to commit funds to small businesses, even in circumstances where they were accompanied by collateral or a guarantee. In addition, most bankers tend to consider the small business proposition from the point of view of a potential risk of loan default rather than the viability of the business or project. This was revealed in the finding of a study where most of the bankers employed a 'gone concern' approach when analysing the financial information of small businesses. This approach focuses on how a loan would be repaid if the business fails rather than the future prospects of the business itself.

CONCLUSION

The agency problems in the relationship between banks and small businesses in Malaysia can cause harmful under-financing to the small business sector. The lack of information can also lead to excessive caution among bankers when assessing loan applications from small businesses. This is further exacerbated by a gap between bankers and small business owners, which is caused mainly by the lack of under-standing among some bankers who often perceive small business owners as a potential portfolio of non-performing loans, and are thus reluctant to help them. To address these problems, bankers need to focus more on understanding the commercial viability of small businesses, their cashflows, and work out procedures for channelling required funds to them. They can obtain valuable information through monitoring the operations of the small business borrowers. This helps in building up their knowledge of small businesses and the potential for viable funding BJM

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