Relational Transaction Lending?
A Study of Commercial Banks in Kenya

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Abstract

The importance of small and medium enterprises (SMEs) in economies has been widely researched, with access to finance emerging as one of the important constraining factors that has to be and is being addressed to enable these firms attain their maximum potential. When financing SMEs, commercial banks can either engage in transaction and/or relationship lending. Traditional literature emphasizes the use of the relationship lending methodology when dealing with SMEs because these firms are considered informational opaque and lack collateral. However, recent evidence shows that transaction-based or arms-length lending can be more cost-effective and also allows larger and non-local banks to lend to SMEs. The objective of this study is to determine how banks make the decision on the lending method to employ when contracting with SMEs. Qualitative research methodology is employed to gain an in-depth understanding of how SME lending transpires in commercial banks in Kenya that lend to SMEs. The data is collected through semi structured interviews and analysed using content analysis. The results indicate that commercial banks employ a mix of relationship and transactional lending technologies when contracting with SMEs and not one method exclusively. The study concludes that we cannot say that any bank employs relationship lending but perhaps, “relational transaction lending”.

Key words: relationship lending, transaction lending
1. Introduction

Significant competition in the corporate and retail sectors has led commercial banks to shift their focus downstream to serve the previously underserved SME market (Calice, Chando & Sekioua 2012; De la Torre, Martinez Pería & Schmukler 2010). Due to their small size and lack of substantial public information about their quality, SMEs depend on commercial banks for their external financing needs because they simply do not have access to public capital markets where they could raise funds (Holod & Peek 2013, Santikian 2014). The informational wedge between SMEs and banks makes the provision of external finance particularly challenging giving rise to debate on how best to serve this sector. On the one hand, small firms with opportunities to invest in positive net present value projects may be prevented from doing so due to adverse selection and moral hazard problems. On the other hand, potential providers of external finance may be unable to verify that the firm has access to a quality project (adverse selection problem) or ensure that the funds will not be diverted to fund an alternative project (moral hazard problem). Banks mitigate adverse selection by screening applicants for loans, and do the same for moral hazard by monitoring borrowers (Diamond 1984, Miwa & Ramseyer 2005). In the case of SMEs, the lack of information with which a bank can make a lending decision is more pronounced and as such research has stressed the importance of the use of the relationship lending method when dealing with these enterprises (Berger & Udell 2006, Carbo´-Valverde, Rodri´guez-Ferna´ndez & Udell 2009, Ono & Uesugi 2009). Relationship lending relies on `soft’ data gathered over the course of a relationship with the borrower (Berger & Udell 2006, Elyasiani & Goldberg 2004). However, there is evidence that transaction-based or arms-length lending can be more cost-effective (Berger & Udell 2006) and it allows larger and non-local banks to lend to SMEs (Beck, Demirguc-Kunt & Martinez 2011).

Previous research has not investigated the role of transaction lending and relationship lending, specifically the interplay of the two methods in making the SME lending decision. This study aims to determine the importance of transaction and relationship lending in making the SME lending decision for commercial banks in Kenya. It examines how banks make the decision on whether to use transaction lending or relationship lending. A multiple case study of five commercial banks that deal with SMEs in Kenya is employed. Those interviewed in each bank are managers that deal with SMEs and who depending on the bank, have one of the following titles: relationship manager, team manager, branch manager or SME head. All these have the same role of handling SME customers’ needs including our subject of interest which is financing SMEs. These managers are generally responsible for acquiring and retaining customers by meeting customer needs.
Results suggest that both transaction and relationship lending are important in SME lending. Commercial banks in Kenya employ either a mix of both methods or transaction lending exclusively, leading to the conclusion that since relationship lending is not used exclusively, perhaps we should not use the term relationship lending but, relational transaction lending.

The paper is structured as follows. Section 2 discusses previous research on SME lending technologies. Section 3 describes the methodology used for the data collection and analysis. Section 4 presents the results which are then discussed in section 5 followed by conclusions in Section 6.

2. Small Business Lending Technologies

Academic interest in the underwriting process associated with commercial lending to the SME segment began around the mid-1990s (Petersen & Rajan 1994). The main focus of these studies was to explore how financial institutions extended credit, particularly how they mitigated the informational gap between themselves and their borrowers by producing information about borrower quality and behaviour. These studies also highlighted the differences between relationship lending and transaction-based lending, more specifically the difference between the use of soft information and hard information (Petersen & Rajan 1994, Rajan 1992, Stein 2002). According to Berger and Udell (2006) small business lending by financial intermediaries is mainly categorized into four main distinct lending technologies – financial statement lending, asset-based lending, credit scoring, and relationship lending. The first three lending technologies are often referred to as transaction-based lending (or transaction lending), under which lending decisions are based on `hard' information that is relatively easily available at the time of loan origination. The last lending methodology relies on `soft' data gathered over the course of a relationship with the borrower (Berger & Udell 2006, Elyasiani & Goldberg 2004).

2.1 Transaction Lending

Transaction-oriented lending focuses on one transaction with a customer, or many standardised and repetitive transactions with various customers. Transaction lending relies more on information that can easily be quantified, commonly referred to as ‘hard’ information. Lending decisions are therefore made after borrowers go through a formally structured application process where they are required to meet certain requirements such as providing specific financial information in order to qualify for a loan (Elyasiani & Goldberg 2004). Transaction lending is viewed as arms-length finance as it focuses on a transaction rather than on information gathered over time from a borrower (Boot & Thakor 2000). Examples of transaction lending technologies are asset-based lending, financial statement lending and credit scoring (Berger & Udell 2006).
Asset-based lending is a type of lending where the collateral is generally accounts receivable and inventory. This type of lending requires that the bank intensively monitor the turnover of these assets and hence is very monitoring-intensive and relatively expensive for the bank. Asset-based lending is available to small firms of any size, but requires that the firm have high-quality receivables and inventory available to pledge as collateral. When this type of lending is referred to as fixed-asset lending, the main data are appraised values of real estate, motor vehicles, or equipment leased or pledged as collateral (Berger & Black 2011). Fixed asset lending is quite cheap for the bank since it does not involve any continuous monitoring activity and only requires an evaluation of the pledge asset(s) when the loan is provided.

Financial statement lending places most of its emphasis on evaluating information from the firm’s financial statements. The decision to lend and the terms of the loan contract are principally based on the strength of the balance sheet and income statements. Financial statement lending is best suited for relatively transparent firms with certified audited financial statements. Thus, it is likely the technology of choice in bank lending to large firms. However, some small firms with long histories, relatively transparent businesses and audited financial statements also qualify for financial statement lending (Berger & Udell 2006).

Small business credit scoring is an adaptation to business lending of discriminant analysis and other statistical techniques long used in consumer lending. In addition to using information from the financial statements of the business, heavy weighting is also put on the financial condition and history of the principal owner(s), given that the creditworthiness of the firm and the owner(s) are closely related for most small businesses (Feldman 1997, Mester 1997).

2.2 Relationship Lending

Several researchers provide complementary definitions of relationship lending which include; “close ties between borrower and lender which facilitates information exchange between the two parties”, (Bhattacharaya & Thakor 1993); “when a firm has close ties to a financial institution”, (Petersen & Rajan 1994); and “a long term implicit contract between a bank and its debtor”, (Elsas 2005, pp.4). Berger and Udell (2006, pp. 3) provides a more comprehensive definition as the lending technology where “decisions are primarily based on soft information gathered over the course of a relationship.” Earlier, Berger (1999) posits that the financial intermediary gathers confidential information through interaction with the borrower over time and usually through the use of multiple financial products/services. Similarly, Freixas (2005) emphasizes that the bank is the one that makes the necessary investment to obtain borrower-specific (often proprietary) information while the borrower has a choice to invest or not. This borrower-specific information is obtained when banks provide
screening (Ramakrishnan & Thakor, 1984) and/or monitoring services (Diamond 1984). This information which is normally referred to as “soft” information is not easily quantified and consists of information gathered over time through contact with the firm and its stakeholders (Berger & Udell 2006). Schwarze (2006) suggests that the more qualitative information is used in credit decision making, “the more one can speak of the granting of credit under relationship aspects”. Using this information over several interactions can be beneficial to both bank and customer (Greenbaum & Thakor 1995). As relationship lending is aimed at resolving information asymmetry problems, it is suited to SMEs which are considered as informationally opaque enterprises (Carbo’–Valverde et al., 2009; Ono & Uesugi 2009). However, although traditional literature has focused on relationship lending as the prime lending methodology for SMEs, there is evidence that transaction-based or arms-length lending can be more cost-effective (Berger & Udell 2006). Beck et al. (2011) add that using transaction based lending also allows larger and non-local banks to lend to SMEs.

The objective of this study is to investigate the role of transaction lending and relationship lending, more specifically the importance and interplay of the two methods in making the SME lending decision. Our specific research questions (RQ) are as follows:

**RQ1:** What lending methodologies are employed by your bank when dealing with SMEs and how do they take a decision on when to use each?

**RQ2:** What is the role of the “relationship” in the SME lending decision (especially between an existing customer and a new customer)?

### 3. Research Methodology

A qualitative multiple case study design is adopted for this study.

A qualitative research approach is found suitable for this study as the research question seeks to determine “what” and “how” as opposed to a quantitative study that asks “why” and looks for a comparison of groups or relationships between variables, with the intent of establishing an association, relationship, or cause and effect (Creswell, 1994). A qualitative inquiry also supports the researcher’s aim of acquiring knowledge and understanding of the problem by using an inside perspective (Creswell, 2009).

Multiple case study design is considered suitable for this study because the researcher aims to explore the research problem in depth using one or more individuals. Yin (2004) proposes that a case study design should be considered when the researcher has little control over events and the focus is on a contemporary phenomenon within a real-life context; as is the case for this study. Evidence from multiple cases adds “confidence” to the research findings and is often more compelling resulting in a more robust study (Herriot & Firestone, 1983; Miles & Huberman, 1994 and Yin, 2004). The five commercial banks selected for this study are those that have been ranked top three, for the years 2010 to 2014, in the banking

Data is collected through semi structured interviews with SME relationship managers/branch managers from each bank. Content analysis is used to analyse the data following the three concurrent flows of activity suggested by Miles & Huberman (1994): data reduction, data display and conclusion verification. Data is first coded into themes which entails looking for similar words or phrases which are then put into categories. Data is then reduced by condensing it into summaries/paraphrases, followed by data display and then finally, conclusions are drawn (Miles & Huberman 1994).

4. Results

All interviewees were asked to provide their demographic information and in most cases the respondents were either the branch manager, SME head or SME relationship manager (RM). To note, is that for this kind of research, the informant had to be an SME manager or at the level of bank management. At the onset, and to be able to answer our specific research questions, respondents were asked to detail the SME lending process. The results discussed below are the themes generated from analysing the qualitative responses from the interviews carried out in banks one (B1) up to bank five (B5).

4.1 The SME Lending Process

All banks were found to have a structured loan application/approval process that starts from meeting the potential credit customer, followed by business visits, completion and collection of required documentation, the approval process and finally the disbursement of funds.

4.1.1 Source of Customers

There was consensus about the source of customer which could either be a walk-in, referral or existing customer as supported by B5, “Customers are usually from one of three sources; walk-ins, value chain referrals from a key customer for example Mumias (a sugar company in Kenya) distributorship or, a segment campaign, for instance an import facility targeted finance.” B2 also added that customers may also be sourced from a cold call, “a customer is introduced or through cold calling.”

There was consensus that for a loan application to be considered, the applicant must have been a client of the bank for a minimum of three months, “must have banked with us for 3 months; we need to understand the business, turnovers so as to estimate need,” as stated by B1.
4.1.2 Business Visit

Typically the relationship manager (RM) or relationship officer (RO) will visit the business premises of the credit applicant to confirm that a business does actually exist and subsequently to establish a need. This is supported by B1, “visit of the business by the relationship officer to establish if there really a business, see the need, establish whether there really is a need, agree and discuss.” B2 in support of this states, “I need to ascertain that he’s based somewhere and he’s doing what he’s saying he’s doing because sometimes we’ve found we have briefcase SMEs and their business is in their car, where would I find him if he defaulted.” The bank would normally visit the customer more than once and sometimes on an ad hoc basis as a way of not only screening initially but also of monitoring, “additionally, an independent verification is done by someone unknown to the customer at an unknown date and time, an ad hoc visit,” B3; “… it helps you to be able to monitor a lot of things which may be in the past if you’re not looking for them, the customer may have been thrown out, stopped selling soap and now they’re trying to manufacture tea bags” (B5).

4.1.3 Collection of Information

Apart from confirming the existence of a business, the business visits also yield additional information that would not be evident during the customer call/visit to the bank. As the customer is in their comfort zone, more information can be collected and this also provides an opportunity to collect soft information. B5 supports this, “we visit the customer premise because SMEs fear banks and get closed in, so sometimes they tell you what you want to hear, but when you meet them at their premise you will still get a lot of information that would be helpful to meet their need.” After the visit(s), the RM/RO prepares a call report which details information about the business, the management, the owners and any other relevant observations. This call report has several sections that allow the RM/RO to put in any additional “soft information” that may impact the lending decision. For instance, in assessing the current business need, the success of the owner in a previous similar business may impact the lending decision as indicated by B5, “…call report profiling of the owners, any other information captured, and previous history of the customer in other business.”

4.1.4 Approval Process

The RM/RO puts together a package of documents that includes; the application form, the call report, financial statements and any other requirements by the bank and forwards this to an analyst. The analyst then prepares a report from the documents provided. This report which may for instance have relevant financial ratios is then forwarded to the approver(s). It is important to note that the call report may contain both hard and soft information. B5 states, “the analyst is given the package and the supporting documents from the customer plus a call report, a document that records information from the first, second interview and includes
profiling of the customer, where their premises are, my (the RMs) view of the business; they get that soft information.” Compared to the RM, the analyst is viewed as the impartial person as he/she does not come into contact with the customer, “this is the objective person, the analyst’s role is the financials” (B5). The approval process may involve several levels depending on the loan amount required; “credit approvers at each stage who must return within 48 hours, there are 3 of them depending on approval amounts,” (B1). At this stage the outcome is an approval, an approval pending amendment or a decline. The documents can move from analyst back to RM / RO if there is clarification needed or from approvers to analyst and back to RM/RO before going back to the approvers, “RM for review can question the analyst’s assessment as analyst may have misrepresented the RM’s position, RM then sends it to the approvers” (B5).

**RQ1:** What lending methodologies are employed by your bank when dealing with SMEs and how do you make a decision on when to use each?

There was consensus about the lending technologies used which tended to fall under the transaction lending methodology. These lending methods were generally asset finance, invoice discounting, LPO financing, overdrafts and term loans as supported by B3, “We have about 14 loan products including asset financing, invoice discounting, loan overdraft, trade finance, working capital, insurance premium financing, among others, we establish what suits your need.” However in all banks except one, there was evidence of the use of soft information, “SME lending is intuitive based i.e. manual intervention is required and depends on the person the client first interacts with to establish the need. There is no rule of thumb, we can proceed from soft to hard information or hard to soft information, this depends on the level of comfort” (B3). This was also comprehensively confirmed by B1, “We look at the character of the directors, cash flows, is it in business, business knowledge of the customer, does the client chase for tenders, how many tenders have they won, is he passionate about the business such that he forced his wife to stop doing a PhD to join him in the business, potential of the business. These facts are looked at before the bank considers what the security is, is it corporate guarantees that the bank can fall back on. The bank can even bend back and require 50% of the security if the soft factors are favourable.” This indicated the interplay of the use of transaction lending (hard information) and relationship lending (soft information). The manual intervention is seen as a necessary interference to enable the SME fit the lending requirements that fall under transaction lending, “SMEs lack data. You have to make the books yourself because if you cannot make them then you will have a very bad book” (B1). Additionally there was also evidence of how banks may be flexible and willing to meet the need of the SME rather than SMEs fitting into the banks’ products, “We do not have products in a bag; we understand the need then package” (B5).
RQ2: What is the role of the “relationship” in the SME lending decision (especially between an existing customer and a new customer)?

The general theme was that the relationship does play a role with the exception of B2 that stated, “The bank does not engage much in relationship lending, relies on transaction lending.” The other banks concurred that in making the SME decision, the relationship plays a role so much so that if it were not considered, some applications would have been unsuccessful, “You cannot have SME lending without relationship management (B1).” B5 supports the role of the relationship, “Maybe 30% of our applications would be declined, if I was to put a percentage; no, relationship lending is key.” B5 further supports the notion that relationships are key in the SME lending decision by providing evidence from the loan application process, “there are different sections in the application and one of the sections is who are the owners and their profile, the management team and its profile and then also the business itself and its profile, those, other than financials, also play a part in the decision making (B5).”

When comparing how relationships affect decision making between an existing customer and a new customer, the consensus was that it favours existing over new customers. “An existing customer is on a scale 70% more likely to get an approval. When you know the client and the business they do, decision making is very quick especially if the customer has a positive relationship with the bank; in a sense, they earn marks” (B1). Existing customers also benefit from special products and concessions, “existing clients also enjoy special products for instance cheque discounting where a client may have a post-dated cheque and needs cash, the bank may pay cash on the strength that this is a client whose cheques are usually paid” (B1). They are also given concessions for instance on collateral requirements, financial statements requirements and for repeat borrowing, “When asking for collateral, an existing client may be required to meet 50-70%, while a walk in client 110%; however this is done on a one on one case basis” (B1). “For an existing person we can do a few concessions even if your statements are not that strong but we can see you’ve been with us for this period and it’s also easier for the existing guy to explain why this statement is like this or why this business is like this. Repeat borrowers also have an advantage compared to new borrowers” (B4).

There was also agreement that the knowledge of prior success in a similar business could also influence the lending decision. However, this information was used together with the bank requirements under transaction lending, indicating that relationship lending could only be used together with transaction lending and not in isolation. Seasoned businessmen or directors that had posted previous successes while in employment were favoured when they started their own outfits. For instance, they may not be required to meet the minimum operational period that is required to be able to apply for the loan, “The bank does not lend to
start-ups; the enterprise has to have been in operation for six months and one year in registration. However if these start-ups do not meet the two requirements but have a seasoned businessman as the promoter, then the bank may reconsider their decision and lend to such an enterprise” (B1). Similar support was provided by bank B3, “If the COO (Chief Operating Officer) of an established company that banks with us starts his own small outfit and would like a facility, he is likely to get it without say meeting the 3 month account requirement because we say “a business is as good as the owners” (B3).

5. Discussion

The commercial banks studied typically follow a formal lending process to assess a loan application. This concurs with Elyasiani and Goldberg (2004) who find that banks have a structured application process which requires borrowers to provide specific financial information and security in order to qualify for the loans. Within this formal process, the bank is able to screen the applicant and collect both hard information and soft information to assist in making the lending decision. This corresponds to Ramakrishnan and Thakor’s (1984) findings that banks obtain borrower-specific information when they provide screening. This study also revealed that banks can go the extra mile to “make the books” since SMEs lack the capability to feed banks with data, which corresponds with Freixas (2005) who emphasizes that the bank is the one that makes the necessary investment to obtain borrower-specific (often proprietary) information, while the borrower has a choice to invest or not. Soft information plays a huge role, in addition to using information from the financial statements of the business; heavy weighting is also placed on the financial condition and history of the principal owner, given that the creditworthiness of the firm and the owner are closely related for most small businesses which coincides with Feldman (1997) and Mester (1997). It is the burden of the RM/RO to make sure that any pertinent soft information is highlighted and presented in a way that is acceptable and can be considered for the loan decision. Generally most banks were in agreement that for an existing customer things would move faster and requirements may not be as stringent.

The general theme was that the relationship does play a role with the exception of one bank that stated that it does not engage much in relationship lending but relies on transactions lending. However, this only goes to further prove that banks cannot solely rely on the relationship to make the SME lending decision but can use either transaction lending exclusively or a mix of relationship lending and transaction lending. Further the use of relationship lending is to complement or fill gaps in the use of transaction lending; in other words soft information can be used to fill in where hard information is unavailable, missing or incomplete. Importantly, this study shows that relationship lending does not occur in a
vacuum but in synergy with transaction lending deviating from those who posit the exclusive use of relationship lending.

6. Conclusions and Future Research

Although traditional literature has focused on relationship lending as the prime lending methodology for SMEs (Berger & Udell 2006), this study reveals that this method cannot be employed exclusively. On paper and especially in practice, clients still have to meet the requirements of hard information; however, this study finds that relationships do play a role in the provision of soft information that helps reinforce the hard information available or especially fill a gap which may exist in the hard information. The results of the study indicate that commercial banks employ either transaction lending exclusively or a mix of relationship and transaction lending technologies when contracting with SMEs and do not show evidence of the exclusive use of relationship lending. This means that relationship lending has to be considered as a contributor to transaction lending and not as an alternative. In other words, relationship lending is only synergistic with transaction lending and not orthogonal nor antithetical to transaction lending.

The study concludes that we cannot attempt to define and say that any bank employs relationship lending as authors including, Bhattacharaya and Thakor (1993), Petersen & Rajan (1994), Elsas (2005) and Berger and Udell (2006) posit because relationship lending is not used on its own but always together with transaction lending. This study therefore proposes the use of the term “relational transaction lending” to refer to the transaction lending method that includes aspects of soft information.

Going forward, it would be insightful to investigate and understand the relationship investment from the customer’s perspective. This may enable banks to develop a better understanding of the way customers make judgments about using and retaining particular banks.

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