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SME Lending Decisions — The Case of UK and German Banks: An International Comparison

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Abstract: In this paper we use five German and UK bank case studies to test and extend a conceptual model of risk assessment in bank lending to SMEs. Derived from research in Germany and the UK the model postulates that factors in the external, operating and internal environments of individual banks can influence risk assessment decisions.

Key words: SME; bank; lending; risk; UK German
JEL codes: D82, K20, G21

1. Introduction

In the words of The World Bank in its 2008 report, Finance for All?

> Empirical evidence suggests that it is through improving access (to finance) for enterprises that financial sector development makes an important contribution to economic growth. (World Bank, 2008, p. ix)

In recent times, a considerable amount of renewed research interest has grown in the area of SME financing, particularly in light of internationalization in the financial markets and EU competition law. Large, global multinational and international organizations are turning more frequently to different sources of finance, including market listings and bond issuance (Lane & Quack, 2001; Deeg, 2000). Large multinationals have considerable advantage over small firms in accessing sources of funding both in the domestic and international markets (Cruickshank, 2000).

Researchers have identified a persistent gap in the funding markets in the case of small firms. However, the idea of funding gaps is not new; Macmillan Committee (1931), Wilson Committee (1971), Cruickshank (2000) all identified funding gaps towards small firms in one form or another. Ross (1996) suggests that there is a general reluctance from the banks to evaluate projects because they view small firms as self-employed individuals.

In this paper we use five UK banks and Five German banks to test and extend a conceptual model of risk externalization in bank lending to SMEs. The model was constructed using qualitative data from interview and case study research in Germany and the UK and postulates that factors in the external, operating and internal environments of individual banks can influence risk externalization decisions.

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2. Research Themes

Baas and Schrooten (2006, p. 129) identify four types of lending types in the interactions between banks and SMEs. The types are identified in Table 1

Table 1 Comparing Lending Types

Lending type	Risk orientation
Relationship lending	Internalisation/co-operative
Financial Statement lending	Externalisation/transactional
SME credit score lending	Externalisation/transactional
Asset backed lending	Externalisation/transactional

Differences in lending behaviour between British and German banks exist because of environmental institutionalisation (Oliver, 1993; Lane & Quack, 2001; Douglas & Wildavsky, 1982). The findings in this research argue that differences in the institutional environment affect firms seeking funds. Different banks have different attitudes towards risk because of influential factors in the environment that impact on their culture, systems, and the behaviour of managers.

Access to finance (Freel, 2000; Storey, 1997; Binks & Enew, 1996) and credit rationing is a major hurdle for growth in the case of SMEs However, research in the area of funding suggested that SMEs were not reliant on external funding, but instead found other sources to fund projects (Cruickshank, 2000).

Traditionally UK banks had been heterogeneous, but during the last two decades, the banking sector in Britain has undergone a number of changes following privatisation, deregulation and EU banking law. Banking in Britain is highly competitive and the activity of mergers and acquisitions in the UK banking market suggest that banks strive to gain competitive advantage through economies of scale following privatisation in order to create barriers to entry. British banks are profit takers and strategically designed to be effective, and do not have the specific goal of serving the local communities, but instead achieve their visionary goals of serving the shareholder (Llewellyn, 2002). British banks easily outperform 4 German banks against their return to equity, for example, British banks have returns in excess of 12 percent on equity and continuously achieve more than most German banks. Llewellyn (2002) found two distinct differences between German and British banks:

(1) STV (stakeholder value).

(2) SHV (shareholder value).

German and British banking systems are different, because German banks operate a higher degree of heterogeneity and are less centralised. One reason that banks in the German financial system are less centralised is because of the strong position held by the commercial and savings banks (Elas & Kranham, 2004). German banks have an orientation towards the common good for their locality and welfare of their members. The banks dominate and control a high proportion of the market (Lane & Quack, 2001; Llewellyn, 2002).

The UK and German systems have been dichotomised in this narrative in order to categorise features.

Access to finance depends heavily on the institutional environment in the individual country. In the most developed environments, UK and US, for example, an increasing trend towards transactional lending is supported by the development of methods of financing small firms in Britain and other European countries are often seen to have significant differences in the way banks allocate credit; Whilst systems and procedures can look superficially similar the reasons for loan application procedure design can differ between national settings (Panopoulou, 1999; Lane & Quack, 2001).

Table 2 Comparing Key Features of UK, German SME Lending

	UK*	Germany*
Number of banks	Few	Many
Size of banks	Large	Medium - Small
Institutional type[1]	Market led	Hierarchical/bureaucratic
Lending type	Transaction	Relationship
Loan term	Short-term	Longer-term
Managerial discretion	High	Low
Collateral	Any available	Business assets
Risk handling	Externalisation	Internalisation
Risk sharing	Little evidence	Collective

Note: * based largely on Lane & Quack, 2001

3. Data Collection

The empirical data for this paper was collected during interviews with five UK lending bankers in June 2006 and five German bankers in February 2007.

The sample ten banks selected were similar in size and operating in the retail environment in their prospective countries. The interviewees comprised of lending officers and managers in loan departments.

All interviews were conducted using a questionnaire format designed to elicit a response to the loan process in an unstructured way.

The questions covered the following themes:

- Loan allocation and specification
- The loan process within the bank
- The level of managerial discretion
- The selection of borrowers
- Rewards and incentives for managers
- Wider loan allocation considerations (e.g., regulation) and
- Underlying bank values

The design of questions was such that environmental, operational and resource based issues would all be highlighted as the loan application process was described. The conceptual model arising from the literature in this area suggests a layered “onion skin” paradigm, based on the work of Bronfenbrenner (1979). The “onion skin” concept is illustrated in Figure 1

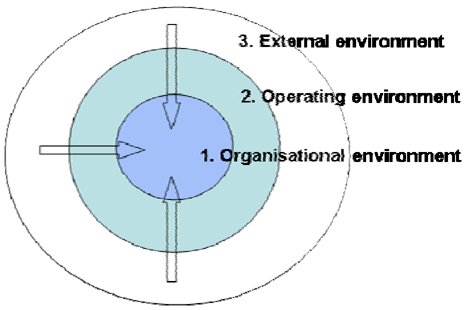

Figure 1 A Conceptual Model of Environmental Influence

[1] Based on Douglas & Wildavsky typology, cited in Lane & Quack, 2001.

All interviews were conducted in English for British banks and some German at German banks. The transcripts were written in English and the German participants signed transcripts following each interview. The questionnaire construction was in English and partly in German. Nonetheless, German participants and the researcher knew the meaning and no translation was required.

The final stage of this process took a number of months but by early 2007 all interview transcripts were approved.

Analysis of the interview transcripts was undertaken using a three-stage coding process that searched for themes. The first level of coding led to clusters of words phrases and themes. Each theme was considered for relevance it is important to note that whilst the interviews were structured using common questions it is the responses given that were analysed. The strength of any qualitative research methodology is that the conclusions are reliable and robust and that the interpretation of the empirical data is able to be replicated.

4. Analysis of Findings

Notable differences emerged from these findings compared to this area of research, the findings of this research argue that EU changes in the law and banking regulations have reshaped both the German and UK banking institutions. German bank employees are facing ever increasing pressure as their employers strive to become efficient streamlined banks with a high orientation towards their new owners in a highly competitive market.

These finding further argue that German banks have moved their value orientations towards the British banking model in order to simulate the high returns achieved by British banks. German banking culture and state values are deeply embedded into the societal structure (Llewellyn, 2002; Lane & Quack, 2001). European law and the deregulation of German banks have manifested in an adjustment of institutional behaviour, steering towards a shareholder orientation. However, even whilst German banks readjust their strategies, they continue to struggle to “shake off” their original roots and a cultural identity of stakeholder orientation.

British banks relied heavily on the use of credit rated scoring to assess borrower default particularly in the case of SMEs and rarely took into account qualitative historical data. However, in some cases historical management data was evaluated for monitoring purposes following the loan approval. German banks took into account the management background of firms, but the emphasis on the importance of qualitative information was lessened. German banks gave a high weighting to the credit history during the loan application.

These findings found similarities between German and British banks in their approach to evaluating loans. German banks had increased the use of credit scoring, considered to be more important than management background, performance, and historical information. Reasons for this change are internal pressures and the need to become more competitive in their respective markets linked to the intensity of rivalry from building societies and European banks entering the retail banking markets.

Perception towards risk is socially constructed based on both individual and bank values. This area of research argues that attitudes towards risk are influenced by regulatory, normative, and cognitive behaviour (Giddens, 1990; Lane & Quack, 2001).

All banks used information about firms according to the banks value orientations, i.e., normative, regulative, and cognitive types; for example, the regulative type guides loan officers to standardise on codes of conduct throughout the lending process, normative types, based on the way banks standardised (culturally) during loan processing. A good example of this was the ceiling levels of credit amounts which varied from bank to bank according to seniority. These findings found that all banks were influencing lending decision by means of both reward and opportunities to promotion following the number of loans granted and the overall profitability at each bank.

Overall, the research found that profitability is at the forefront of the main private banks in Germany, and German banks to alter their business model towards that of the British banking system. However, the transition for change involves the dismantling of traditional values such as the stakeholder approach and an orientation towards the goodness of the community will require time. British banks continue to embrace the values of the shareholder approach, which involves a less risk adverse approach.

5. Conclusions

Banks in both the UK and Germany have unifying values oriented to growth and profitability, and filters down to how lending officers perceive risk. The guarding of an organisation's values may influence and shape the perceptions of risk into threats rather than opportunities for the bank; hence, the avoidance of risk, through a huge presence of collateral, normally required from SMEs. However, German banks are more proactive in the encouragement of risk sharing through partial state absorption and inter-bank risk sharing, evidenced by cooperative banks.

The key differences between the UK and Germany are, therefore in the external environment, the nature and maturity of credit registry systems and accounting and reporting procedures. The design of the risk-averse due-diligence procedures and the hierarchical sanctioning of loans are products of the risk environment. Although this design architecture looks similar to that found in

As with any individual research project there are limitations with this research, largely due to the small sample size and the original focus of the conceptual model. Future research could usefully focus on the key environmental factors of the availability of good quality accounting and credit information and the creation of credit registries

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