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The Bank Financing of Small Unlisted Firms in the UK: An Analysis of Recent Conflicts

Kevin Keasey
Robert Watson

This paper examines the characteristics of UK small firm bank finance and the causes of the frequently strained relationship between small firms and banks in the UK. Debt, credit rationing, and call option problems under the UK system are examined. The bank's solutions including the potentially harmful "secured overdraft system" are then considered. It is argued that the majority of solutions tried by the banking system led to a heightened conflict of interest between small firms and banks during the recent recession due to the banks' loan restructuring to avoid unnecessary risk.

I. INTRODUCTION

This paper examines the bank financing of UK small businesses and the institutional factors responsible for the frequently strained relationships between the two parties. An apparently perennial strain upon UK small firm/bank relationships has been the perception that 'credit rationing' exists (the so-called 'finance gap'), particularly in relation to long term finance, and that there has been a lack of transparency regarding the pricing and assessment by the banks of their small business lending risks. Of course, it is probably inevitable that some element of 'credit rationing' will arise simply as a consequence of conflicts of interest and costly to remedy asymmetric information (the problem of agency costs). Nevertheless, it is argued that additional tensions between UK small firms and banks in the early 1990s were generated by three factors; namely, the recent macroeconomic instability and regulatory changes outside of either party's control, the particular type of debt financing

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(the 'overdraft' system) used and the oligopolistic banking market and associated bureaucratic organizational structures of UK banks.

Throughout their history the four main UK clearing banks have been primarily retail deposit takers specialising in holding government debt and the provision of short term advances. Consequently, unlike the "investment banking" systems of many other European countries, the UK clearing banks were never involved in any major way with supplying long-term debt or equity finance to UK industry (see Collins, 1991). In addition, the small firm sector has historically been a relatively minor component of both the UK economy and the banks' lending portfolios. Until the 1980s, domestic competition between banks for small business custom was very limited and lending decisions were typically at the discretion of the local branch manager. As predominantly retail deposit takers, the branch level of UK clearing banks does not normally contain specialist personnel competent in small business risk assessment. Branch managers, rather than committing valuable resources to detailed assessments of individual small business risks, have generally been content to make available short-term advances secured on the business and personal assets of owner-managers.

While the domestic UK banking system has been opened up to much greater competition since the mid 1980s, the majority of advances made by the main clearing banks to small business continues to be predominantly in the form of secured overdrafts (line-of-credit) and, to a lesser extent, other forms of short-term loans (see Keasey & Watson, 1995) for a review of the empirical evidence). Though legally repayable on demand, in practice the overdraft is a significant source of long-term finance since the banks do not normally reduce previously agreed limits for accounts in good order. Thus, the overdraft is a more-or-less permanent, though variable, item on many small firm balance sheets.

The severe economic downturn in the UK in 1990, however, produced complaints from small businesses that the banks had begun to unilaterally withdraw or significantly reduce previously agreed overdraft facilities at short notice and without just cause. Since in the majority of cases, the firm is unable to raise the cash resources to immediately repay the overdraft, it is forced into liquidation. As the overdraft is normally secured via a floating charge on the firm's assets, upon liquidation the banks are able, via their secured creditor status, to obtain full repayment ahead of all other (non-statutory) third party claims. While from the banks' viewpoint, this simply involves the exercise of their put option in order to recover their investment when they perceive that default probability has increased significantly, small business representatives,

politicians and media commentators have generally interpreted the banks' actions as destructive and as forcing viable businesses into unnecessary liquidation.

Although several official inquiries have found no evidence of bank misbehaviour (e.g., see the "Bank Cleaned...", 1991; "Office of Fair Trading...", 1991; and "Research Retakes...", 1992), it is argued below that the UK banks' reluctance to expend resources in the monitoring and assessment of firm-specific risk and to simply rely upon the put option characteristics of the secured overdraft, contributed to the conflict. However, other contributory factors can also be identified. These include the large increase in the number of (often economically marginal) enterprises created during the 1980s, the greatly increased domestic and international competition confronting the UK banks over the same period and the economic downturn in 1990 which falsified the assumptions upon which previous lending decisions had been based. As the proportion of small firms experiencing financial difficulties increased dramatically after 1990, the ability of the banks to respond in a manner which accurately reflected changes in their exposure to individual, firm specific, risks was limited due to organizational and cultural constraints internal to themselves.

The remainder of the paper is structured as follows. The next section briefly describes recent changes in the UK small firm sector and the organizational characteristics of the owner-managed firm which exacerbated the inherent agency conflicts associated with debt financing. Section III discusses, with particular reference to small firms, the call option characteristics of equity which exposes the debt supplier to uncompensated, ex post, business risk. This section also reviews the theoretical asymmetric information credit rationing literature and the UK banks' traditional solution to these agency problems. In Section IV we discuss how the structure of banking in the UK, along with the marked macroeconomic instability of recent years, has impacted upon the small firm/bank relationship. The final section considers the implications of the discussions for the relationships between small firms and banks in the UK.

II. THE UK SMALL FIRM SECTOR

Although the small firm sector has become an increasingly important part of the UK economy over recent years (see Stanworth & Gray, 1991) it is generally recognized that investors in small enterprises will invariably be exposed to a high level of business risk. Indeed, as a

consequence of the government's financial deregulation initiatives and its promotion of the small firm sector during the boom years of the late 1980s, the UK economy had by 1990 a greatly increased number of young and highly levered firms (see Bank of England, 1991; Keasey & Watson, 1992). Failure rates are particularly high for new firms, those developing radically new products and/or those producing for new markets. Typically, the vulnerability of firms to failure is recognized as being greatest in their earlier years; for example, Ganguly (1983), based upon official Value Added Tax (VAT) data, found that of those firms formed in any year 12 percent will fail in their first year, 26 percent within two years and 36 percent within three years. Moreover, as evidenced from the compulsory liquidation statistics produced in Table 1, rates of failure are dramatically increased during economic recessions.

However, even for well-established firms, business risk can still be expected to be high since it is likely that they will be characterized by one or more operational, organizational and/or informational deficiencies. Operational factors which are both typical of many small firms and which can be expected to increase business risk include a low degree of product and/or market diversification, reliance upon relatively few customers and/or suppliers and, therefore, limited market power. Additional financial contracting difficulties arise due to the owner-manager's dual roles as the sole managerial resource and the main equity investor. The lack of a full management team, often also associated with the lack of any clear succession once the owner-manager retires, renders the future viability of the enterprise wholly contingent upon the continued good health, energies, business acumen and financial probity of the owner-manager (Keasey & Watson, 1993).

The above characteristics tend to limit the range of possible sources of finance and, not surprisingly, a number of government sponsored Committees of Inquiry (Bolton, 1971; Macmillan Committee, 1931; Wilson, 1979) have concluded that an economically important 'equity finance gap' exists in respect of unlisted small firms. Consequently, due to the absence of willing outside equity investors, UK small firms are almost totally dependent upon short-term bank loans and overdrafts to finance their investment and operational requirements once the owners' wealth resources have been fully committed.

The lack of publicly traded equity or debt creates considerable uncertainty regarding the value of small firm assets and financial claims. Clearly, a major difficulty for outside creditors is that the closely-held, owner-managed, firm is almost inevitably going to create severe

information asymmetries which may be difficult and/or excessively costly to overcome. In this context the financial reporting requirements applicable to UK small firms compound the problem since they are considerably less onerous and less vigorously enforced than is the case for widely-held, publicly-listed enterprises (Keasey & Watson, 1988).

The lack of readily available market price and accounting information can, therefore, be expected to generate high information and exit costs for investors wishing to realize their investment. Such information asymmetries are a major source of agency costs since it provides opportunities for owner-managers to take actions which may be detrimental to the financial claims of other stakeholders. Moreover, as subsequent sections will indicate, the incentives for the owner-manager to gamble with outside investors' claims are greatly enhanced when, for whatever reason, the firm becomes financially distressed. As both the choice of what projects to undertake once the necessary finance has been acquired and decisions regarding the level and pattern of owner-manager withdrawals of equity (via remuneration and/or dividend payments) are under the control of the owner-manager, traditional performance measures such as accounting profits, even if available, will generally be of limited relevance to an outside investor. An outside investor's security will normally be restricted to the net realizable value of the firm's tangible assets. Only these funds (net of any realization costs) will typically be available for distribution to creditors in the event of business failure. This implies that, unless alternative control mechanisms are available, unsecured outside shareholders, debt suppliers and trade creditors will have to incur non-trivial monitoring and information costs.

III. MODELS OF FINANCIAL CONTRACTING

The Debt Contract

The central feature of a debt contract is that it is meant to be a legally enforceable agreement which ensures that the debt supplier obtains a prespecified rate of return and schedule of repayments from the debtor irrespective of the financial circumstances and returns that accrue to the latter. During the life of the contract, the basic problem for the creditor is how to ensure that the previously agreed return is obtained if the debtors' financial circumstances deteriorate to the point where default becomes a possibility. In this situation, because of the (downward) truncated return distribution associated with limited liability, owner-managers' incentives become distorted due to the low

value of their equity claims. Thus, when firms are financially distressed their owner-managers do not bear the full costs of their decisions and this provides an incentive to gamble with creditor claims.

As Black and Scholes (1973) have indicated, because of limited liability, the payoff function to a risk neutral owner-manager of a levered firm is analogous to that of a call option:

$$\text{Max } [V_t - (1 + i)L_{t-1}, 0] \quad (1)$$

where V_t is the value of the firm at time t , L_{t-1} is the amount owing to outside investors (primarily trade creditors and banks) at $t - 1$ and i is the effective interest rate on the outstanding liabilities for the period $t - 1$ to t . This, as Stiglitz and Weiss (1981) have noted, is a convex function which, because of the restricted downside potential, motivates the owner-manager to act in a more risk preferring manner. Quite simply, in the event of failure (that is when $V_t - (1 + i)L_{t-1} < 0$) an 'uncompensated wealth transfer' will occur since part of the cost of failure (that is, $(1 + i)L_{t-1} - V_t$) will be borne by the creditors. Thus, whenever default becomes a possibility (i.e., $E(V_t) < (1 + i)L_{t-1}$), the owner-manager has an incentive to take actions which expose creditors to greater risks and which further reduce the value of their financial claims.

To illustrate some of the main ex post difficulties faced by the debt supplier, assume for simplicity that no new liabilities or new equity has been injected over the period $t-1$ to t . In this situation, the value of the firm at the end of the period, V_t , is simply a function of the value of the firm at $t - 1$ (V_{t-1}), the profitability of the firm (P_t) and the owner-managers' drawings (D_t) over the period:

$$V_t = V_{t-1} + P_t - D_t. \quad (2)$$

However, since $V_{t-1} = E_{t-1} + L_{t-1}$, the above can be expressed as:

$$V_t = E_{t-1} + L_{t-1} + P_t - D_t. \quad (3)$$

Clearly, in order for the firms' creditors to be fully paid, that is, for it to be worthwhile for the owner-manager to exercise his/her call option at time t (i.e., to repay the debt), the end of period equity (E_t) must be greater than zero. Thus, the following condition must hold:

$$(E_{t-1} + L_{t-1} + P_t - D_t) - (1 + i)L_{t-1} > 0 \quad (4)$$

$$E_{t-1} + P_t - (i)L_{t-1} - D_t > 0. \quad (5)$$

Hence, from the above, it is clear that the probability of default can be expected to increase as the initial equity position (E_{t-1}) and expected profitability (P_t) fall and when the initial debt level (L_{t-1}), the interest rate on the debt (i), and owner-manager drawings (D_t) increase. It is important to note, however, that at the time of the decision to lend L at $t - 1$, the outside creditor will only be able to directly observe E_{t-1} and L_{t-1} . He/she will, at best, only have historic track records and/or forecast figures regarding both P_t and D_t .

Although information regarding likely profitability in the coming period, P_t , may be available at $t - 1$, the actual value of the firm at time t may turn out to be very different from that anticipated. This could occur if the owner-manager decided to choose a project with a different risk-return profile and/or he/she significantly changed the pattern and level of his/her drawings over the period $t - 1$ to t . In addition, P_t may be significantly adversely effected by exogenous changes in macroeconomic conditions. The potential for conflicts of interest to arise is, therefore, greatly increased during economic downturns and this further increases the incentives for owner-managers to act in a manner which results (by accident or design) in a shift in the distribution of business risk onto the creditor.

Given the above, a debt contract will normally contain some provision which relieves the original owner of control when he/she no longer bears the full costs of his/her decisions, that is, when the firm is perceived to be financially distressed. Indeed, from the perspective of the debt supplier, the essence of an efficient debt contract is that the allocation of control, but not the return, is contingent upon a measure of firm activity. Basically, the owner-manager remains in control if the measured activity is "good" while the outside investor takes control if it is "bad." The debt contract, by specifying the point at which control of the enterprise changes, implicitly determines the point of insolvency. By creating through the debt contract an ex ante mechanism of control transfer, the contracting parties have effectively made financial distress endogenous—financial distress being merely those "bad" states where the contracting parties have ex ante agreed to transfer control to the outside investor (see Bergloff, 1990 for a review). Of course, in practice, because of the closely-held organizational form and other contracting difficulties associated with small firms, non-trivial information asymmetries will normally exist. In the absence of owner-manager co-operation, an outside investor may therefore find it difficult to become sufficiently well-

informed at an early enough stage to avoid sustaining substantial uncompensated losses. Such a view appears to underlie the theoretical credit rationing models discussed below.

Credit Rationing Models

In recent years theoretical asymmetric information models have increasingly been used to examine financing problems. Most of these models have also come to the conclusion that credit rationing of one form or another will exist if lenders are unable to overcome such information asymmetries (e.g., see De Meza & Webb, 1990). Information asymmetries can be of three forms—adverse selection, moral hazard and costly state verification. Adverse selection occurs when borrowers differ with respect to the probability of repaying their loan and the banks are unable to judge the probability of an individual loan being repaid. The banks, therefore, have to offer a blanket rate of interest to all loan applicants. However, as the rate of interest on loans may affect the average quality of loan applicants (e.g., low risk borrowers may exit the market if interest rates rise) this asymmetry of information may lead to credit rationing as banks attempt to imperfectly classify borrowers into different categories and choose not to charge a market clearing loan rate which may lead to an overall worsening of the pool of loan applicants.

The problem of moral hazard in relation to the provision of finance focuses on the effect that high interest rates may have upon the unobservable behavior of the firm and the project undertaken with the loan. For example, if lenders attempt to cover potential losses simply by charging higher interest rates, this could induce firms to undertake riskier projects and, therefore, as in the adverse selection situation, the banks may choose to ration funds via methods other than a market clearing rate of interest. Thus, the asymmetry of information in either the adverse selection or moral hazard case concerns the riskiness of the project for which a loan is used rather than the eventual outcome of a project.

In contrast to the situations of adverse selection and moral hazard, costly state verification occurs where the lenders know as much as the borrowers about the riskiness of the projects being funded, but only the borrower is able to observe his project returns costlessly (see Williamson, 1986, 1987). In this situation the firm has an incentive to declare a return so low as to make it impossible to pay off the debt to the bank, even if the return is actually far higher. Banks respond to this incentive by committing themselves to incur costly monitoring of the project

returns of firms that file for bankruptcy/insolvency. As for adverse selection and moral hazard, however, the banks have an incentive not to charge a market clearing rate of interest. This is because the probability of bankruptcy is a positive function of the rate of interest and the banks will need to balance the increased monitoring costs with the increased monies achieved from higher rates of interest.

All of the above explanations of credit rationing rely upon information asymmetries and changes in the rate of interest adversely affecting the quality of the loan portfolio or the costs of monitoring. This has the consequence that banks have to imperfectly ration loans through means other than the rate of interest. Although the credit rationing literature has added a degree of mathematical rigor to the analysis of credit decisions, it is, however, deficient in capturing the nature of the relationship between small firms and banks. First, as a general point, the results of the theoretical models are not robust to plausible changes in important assumptions. For example, the common result of an underinvestment equilibrium was overturned by De Meza and Webb (1987) simply by changing the assumption that all projects have the same mean return. Second, the analysis assumes the relationship takes place solely via a standard debt contract with a known probability of default. Thus, although the banks are able to optimally adjust the interest rate they charge on loans, they have no other contract instruments under their control. Interestingly, when Bester (1987) included a collateral requirement in his model, he was able to derive an equilibrium free of the normal credit rationing conclusions. This is because assets used as collateral with a net realizable value at least equal to the face value of the debt, is analogous to a put option which guarantees that the lender will receive the expected payoff irrespective of what happens to the ex post profitability of the firm (that is, P_t). If the debt is also short-term and/or subject to frequent review, then the lender effectively has an "American put option" which can be exercised at any time throughout the loan period. Moreover, if the assets used as collateral are the borrower's personal (i.e., non-business) assets, then the lender need not be concerned with the borrower's withdrawals of equity (that is, D_t) either. This solution to the contractual difficulties associated with small firm lending, does not require significant expenditures on risk assessment or the close monitoring of the borrower's actions. Also, because the collateral requirement safeguards the lender's investment, it can be expected to increase the availability of debt finance and/or lower its costs significantly.

If the ability to provide collateral is, however, a function of wealth and borrowers are risk averse, Stiglitz and Weiss (1987) have shown that relying exclusively upon a collateral requirement will not be sufficient to avoid credit rationing or the issues of adverse selection and moral hazard. Where competition between lenders is active, it might be expected that firms with insufficient collateral would be willing to bear the costs of monitoring and higher interest rates that incorporated the correct assessment and pricing of risk. If, however, current lending institutions are geared exclusively towards providing loans on a put option basis, this change in lending policy would require lending institutions to invest heavily in acquiring the specialized knowledge and skills necessary to undertake meaningful risk assessment and the monitoring of the borrower's business decisions. The probable high setup costs associated with such a change in lending arrangements may prevent it from happening, particularly if lenders perceive that they will be unlikely to recoup these costs from borrowers without causing adverse selection problems which results in significantly increasing the riskiness of their loan portfolio.

The above discussion indicates that the theoretical credit rationing models are not institutionally rich and are, therefore, limited as an aid to understanding the empirical relationships between small firms and banks. Not surprisingly, given the mathematical complexities of the credit rationing models, there is a relative absence of empirical work which can directly test the various implications of different models. One notable exception is the work by Berger and Udell (1989). Their results reveal substantial rigidities in commercial loan rates and this is consistent with the presence of credit rationing. However, they present additional evidence which suggests that the quantitative impact of credit rationing is likely to be relatively small and furthermore, the rigidities in interest rates were found to vary with contract details counter to the conclusions of the general credit rationing models. The evidence of Berger and Udell suggests, therefore, that other models of the bank financing of small firms might be usefully developed and explored. The emphasis of recent developments in the theoretical literature has been to alter the assumptions made regarding borrower characteristics—the type of returns distribution, the risk preferences of the borrowers, etc. To date, the (organizational, market or regulatory) characteristics of the lenders have played little or no part in these models. In other words, the credit rationing models have been largely driven from the demand side with the supply side being characterized as a 'responsive' perfectly competitive

situation, a characterisation which does not appear to be empirically well founded for the UK.

The UK Secured Bank Overdraft System

The majority of debt finance from the main clearing banks to small businesses is advanced using the secured overdraft/short-term loan system. As already noted, this solution adopted by the UK banks to the contractual problems outlined above is analogous to their purchase of a "put option" with an exercise price set equal to the outstanding debt ($L_{t-1}(1 + i)$), assumed to be lower than the net realizable value of the collateralised assets. With this system, at any time after the loan has been provided, the bank has the ability to call-in the loan (an "American" put) and be paid in full ahead of all other financial claims. This protects the bank from down-side business risks, requires little monitoring or risk assessment and allows the banks to charge significantly lower interest rate premia (approximately 2 percentage points lower) on secured small business lending (see Keasey & Watson, 1995).

The other main characteristic of the overdraft system is its "flexibility" which, in normal circumstances, has benefits for both parties. Normally, the borrower negotiates an 'overdraft limit' with the local branch manager. This then allows checks to be drawn at any time on a current account in excess of the funds available up to this limit. Hence, the actual amount borrowed will vary depending upon what checks the account holder draws or deposits in this account. As noted earlier, the major advantage of the overdraft system for the borrower vis-à-vis a fixed term loan is its flexibility. Interest is only charged on the amount by which the account is overdrawn and there is no fixed repayment schedule. One advantage to the bank is that the interest rates charged on outstanding balances can be varied contractually at the bank's discretion.

Although legally the overdraft facility could be withdrawn at any time, the banks normally allow a reasonable period of notice to enable the firm to obtain finance elsewhere before requiring either a reduction in the overdraft limit or the repayment of the total balance. In 'normal' circumstances, it is extremely rare for a bank to withdraw an overdraft facility, this is after all a fairly profitable line of business for the banks. In consequence, the financial planning of many small firms is frequently based on the assumption that their overdraft limit represents a permanent source of long-term capital. This behavior rarely appears to be a cause for concern in periods of economic prosperity, provided that the firm stays within its agreed overdraft limit and is able to service the

interest payments. However, major problems surface when an economic downturn occurs and the firm is either unable to stay within its overdraft limit or, because of the poorer prospects for the firm, is required by the bank to make arrangements to reduce its overdraft by some significant amount.

IV. RELATIONSHIPS AND THE STRUCTURE OF UK BANKING

Small Firm Banking Relationships

The structure of banking within the UK and how this impacts upon the small firm/bank relationship is now considered. In examining the history and structure of banking within the UK, major differences with banking in the US are noted where appropriate. The discussion indicates that the market and organizational structures of banking can be expected to have an impact on the relationship between the small firm and the bank. The work of Petersen and Rajan (1994), who show that the closeness of a relationship impacts upon the availability of loans, is discussed before going on to consider how the structure of banking affects the closeness of small firm/bank relationships in the US and the UK.

Petersen and Rajan's notion of a relationship is that long-term or close/intense relationships provide more information to the parties about each other. For example, with a long-term 'relationship', bank lenders will be better able to judge the risk characteristics of a specific loan. The ability of a relationship to overcome information asymmetries is basically a function of its duration and its scope. Hence the longer a relationship has been in existence, the better the lender should be able to judge the risk characteristics of a further loan proposal. Equally, where a relationship involves a range of products, the lender should have more information on which to base his/her loan decisions.

Whether the benefits of such increased information (via an improved pool of lending decisions) is passed on to the borrower depends upon competition in the market place for capital; which in turn depends on the specific forms of the relational information and the market place. If the information available from the relationship is purely private and cannot be accessed by other external lenders, then it is doubtful whether it will necessarily lead to a lower cost of loans—the rents being extracted by an essentially monopoly provider. However, the monopoly provider may be more willing to provide funds under this increased information

situation. Hence, even if relationships do not lower the costs of funds to small firms, they may increase the availability of loans. This latter proposition is supported by the empirical evidence reported by Petersen and Rajan which indicated that the presence of a long-term relationship was associated with an increased availability of finance.

The structure of the lending market may influence the formation of particular types of relationship and/or have an effect upon the duration and scope of relationships. The one empirical fact to come out of the Petersen and Rajan study, and this supports the argument of Mayer (1988), is that concentration in a local market is beneficial to the development of a close relationship which allows the bank to reap the benefits of being 'helpful' at an early stage of the relationship. Furthermore, concentration in a local market is more likely to lead to a durable relationship with wider scope because of a lack of viable alternatives. However, in a non-competitive situation there are few incentives for lenders to incur the costs associated with obtaining a more adequate understanding of the risk characteristics of borrowers if default costs are solely borne by the latter. Indeed, in this situation, the costs of information gathering would be a deadweight cost without any corresponding benefit to the lender.

Ellehausen and Wolken's (1990) research on the use of banking services by small and medium sized firms in the US found that small enterprises obtained virtually all their financial services from local (within a 30 mile radius) financial institutions. Moreover, Ellehausen and Wolken suggest that, because the local commercial banks provided multiple services, they were the single most important financial institution for nearly every small and medium sized business throughout the US. The emphasis upon the local bank clearly has an impact on the type of relationship that might endure between small firms and banks. The local banker will have a greater personal knowledge of his/her customers and their business affairs. On both these grounds, he/she may be able to accept classes of business which the large institution, without an intimate knowledge of the locality, may see as too risky to take on province. In this way, the local bank may be able, at least in part, to offset the advantage held by larger institutions in securing a wider spread of risks—both regionally and as between industries; whether the larger banks effect this by a means of branch networks or an agency of correspondents. Thus the advantage enjoyed by small-scale, local US banks is the ability to maintain a relationship through a detailed knowledge of specific circumstances and enjoying the flexibility to adjust policies accordingly.

The UK Banking System

The UK banking system is quite different in structure to that of the US. The system is based on four major clearing banks (National Westminster, Lloyds, Midland and Barclays) who operate nationwide via an extensive branch network. Of course, in any one geographic location there may be more 'competition' between branches of the 'Big 4', in terms of the range of services provided, than is the case for the local unit bank system of the US. However, by any criteria, banking in the UK is highly concentrated and this has consequences for small firm/bank financial contracts and relationships.

Even so, since 1980 the UK banking sector has faced increased domestic and international competition due to several public policy initiatives that have significantly altered the economic and regulatory environment within which they operate. For example, the abolition of exchange controls has opened up the UK domestic market to international competition, while financial deregulation legislation has allowed other financial institutions (such as building societies) to offer a full range of banking facilities including the provision of current accounts. As a consequence the UK banks were no longer able to rely upon an uncompetitive domestic market to supply them with a cheap source of funds from non-interest bearing current accounts. This, along with the 1987 Basle Agreement which increased the minimum capital adequacy ratios of banks, significantly increased the costs of making loans.

As profit margins on lending were squeezed, the banks competed more vigorously in terms of the prices of their other services. This led to the elimination of implicit cross-subsidisation and to the passing on to the customer of the costs of supplying specific services. Hence, while those customers with deposits gained from a more competitive rate of interest, charges for many other services had to be introduced and/or be increased to reflect the marginal cost of supplying these services. This, as might be expected, made banks unpopular with customers who previously obtained these services free or at a subsidised rate (see Chrystal, 1992).

Despite these environmental changes, and in spite of much criticism from small business representatives when the bank uses its put option, the secured overdraft still remains the primary form of bank lending to small firms in the UK. Although more competition within the UK banking sector could have led to more sophisticated financing this has not been the case. Rather increased competition has simply resulted in

an increased willingness to provide secured overdraft finance (see The Bank of England (1991) for empirical evidence). This can be explained by at least two factors; an inability and/or unwillingness of small firm owner-managers to obtain external equity financing and/or to countenance a greater bank involvement with their businesses (see Cowling, Samuels, & Sugden, 1991) and the lack of incentives for the major UK clearing banks to change their lending policies.

An obvious advantage to the banks of overdraft financing is that it limits the judgement required in lending because branch managers only have to assess the adequacy of the assets used as security and the ability of borrowers to repay in a short time. Relatively unsophisticated lending criteria can be used as there is no need to assess the longer term profitability of the business. Hence, the expected incremental benefits of improved information flows associated with the development of close relationships with borrowers are unlikely to be sufficient to give the banks a strong incentive to change their lending practices in this direction. Moreover, as in most oligopolistic markets, there are big disincentives for any one player to step out of line with what other players are doing. The concentrated structure of UK banking is at least partially responsible for the highly stable (though with occasional bouts of "follow-the-leader" behavior) and essentially identical lending behavior observed across the main banks.

Another major disincentive to change is that the secured overdraft system, because it does not need highly developed lending or risk assessment skills, fits in extremely well with the existing appointment and career promotion systems of, what are essentially, nationwide, hierarchically organised, retail banks. This nationwide retail structure requires managers to be sifted for promotion up a long hierarchy. Temporarily occupying a number of positions from branch manager and below in a number of different geographic areas appears to be an essential part of this internal labor market process. The use of overdraft finance facilitates this internal labor market process because the bank manager only needs to respond to the national headquarters' edicts regarding changes in lending policies. Although the branch manager has some discretion in deciding when to call in an overdraft, a dispassionate distance in the relationship may be an advantage as personal commitment is not allowed to cloud the issue. Thus, the arms length nature of overdraft financing facilitates the career processing needs of the highly concentrated, hierarchical retail banking sector and this concentrated retail-based structure prevents major changes in lending behavior.

As with other oligopolistic industries, UK banking regularly exhibits "follow the leader" behavior in that the 'Big 4' closely track each other in terms of their market actions. A recent example of this was the increased attention by all four banks on small firms in the mid to late 1980s which resulted in the 'Big 4' clearing banks greatly increasing their total funding to a greatly increased UK small firm sector. The banks were able to do this because any significant changes in the risks associated with competing in this market place would largely be borne by the small firms themselves. Thus when the recession came in the early 1990s and the assumptions of the boom years of the mid to late 1980s did not materialise, the banks simply responded as they had always responded and withdrew or reduced their overdraft facilities to firms which appeared to be entering financial difficulties. However, not surprisingly, this calling in of overdraft finance by the banks in the early 1990s has led to conflict and extensive complaints by small business representatives who argued that the banks have a responsibility to lend on a sound basis and to maintain lending to allow businesses to ride out any temporary financial difficulties.

Empirical Evidence

To illustrate how the structure of UK banking and the extensive use of secured overdrafts has impacted upon small firm/bank relationships, this section briefly reviews the available empirical evidence on the bank financing of UK small firms. A study of the bank financing of a sample of 110 small firms by Keasey and Watson (1992) indicated that bank finance and owners' equity provided almost equal proportions (about 31% each) of the overall funding of small firms in 1990. Furthermore, 55 percent of the total funding of small firms was short term, with the banks and trade creditors each providing roughly a third of this short term finance. Of the longer term bank finance, approximately a third was unsecured. The majority of both the bank overdrafts and longer term loans were secured on either just the directors' personal assets or a combination of business and personal assets. The average security ratio of assets to loans was slightly under three, which is remarkably similar to the figures reported by both Cowling et al (1991) and Binks, Ennew, and Yead (1992). The study also indicated an increased reliance upon short-term debt relative to equity over the expansionary period to 1990 and this certainly increased the vulnerability of firms to the subsequent economic downturn. This increased reliance upon short term debt is also reported by the Bank of England (1991). Basically, there is overwhelming evidence

Table 1
UK Macroeconomic Indicators: 1985 to 1992
(4th Quarter Figures)

<i>Year</i>	<i>Company Liquidations— England and Wales)</i>	<i>UK FT All- Share Index</i>	<i>Rate of UK Wholly Unemployed</i>	<i>UK* GDP</i>	<i>Rate of Change in House Prices— Yorkshire</i>
1985	14,898	682.9	11.0	86.1	5.2
1986	14,405	835.5	11.1	90.4	7.2
1987	11,439	870.2	9.3	94.5	9.4
1988	9,427	926.6	7.4	98.6	40.4
1989	10,456	1,204.7	5.8	99.8	24.2
1990	15,051	1,032.3	6.3	99.1	1.3
1991	21,827	1,187.7	8.9	97.5	-0.1
1992	24,425	1,363.8	10.4	97.7	-4.1

Notes: *June 1990 = 100.0
House Price series provided by the Halifax Building Society.
The rest of the series are taken from Datastream.

that the major clearing banks in the UK played a major part in fuelling, on the back of overdraft financing, the growth of the small firm sector and general boom conditions in the UK economy during the late 1980s (see Table 1).

The study by Keasey and Watson (1992) also indicated that the clearing banks, in their haste to chase available business during the mid to late 1980s, had left themselves increasingly exposed to an economic downturn. Thus although the average profitability of the sample was consistently high over the six year period up to 1991 (for instance, in 1990 the average profits before interest payments and directors fees as a percentage of turnover was approximately 16%), in each year directors' fees were approximately some 70 percent of total operating profits. Since this represents funds withdrawn from the business, it is clear that typically only a small proportion of the firms' earnings will be directly available for satisfying claims of creditors. Nevertheless, the banks can be expected to be most concerned with the security of the lending rather than with the firm's profitability. This is supported by the empirical findings of Keasey and Watson (1995) who found that the risk premia charged by banks on small firm overdrafts/loans were positively related to firm specific risk factors such as leverage and a lack of asset backed security.

With the onset of the recession in the early 1990s, the earlier dash by the major banks for small firm lending was replaced by a concern over the poor quality of the past lending to small firms. As can be seen from Table 1, during 1990 property prices and GDP fell and dramatic increases in the number of company liquidations occurred. Since property was the basis of the banks' put option, overdrafts were called in or limits tightened, which further increased the number of small business failures. Keasey and Watson (1995) also found that small firm interest rate premia increased by approximately three percent as the UK economy turned towards recession after 1990.

V. DISCUSSION AND CONCLUSIONS

This paper has considered the nature of small firm/bank relationships in the UK. It has been argued that the relationship can only be understood if three factors are borne in mind—the special nature of small firms and their operating environment, the structure of banking in the UK and its use of overdraft financing, and the impact the general macro-economy has on the relationship. During 1991, the main UK clearing banks were on the receiving end of a lot of criticism from small businesses, particularly those experiencing financial difficulties. The criticisms were wide ranging and included claims of insensitivity over the handling of small firm accounts, over-charging in terms of interest payments, of applying bank charges without informing the customer, being overly eager in calling in their loans and demanding too high a level of security. The media and small business pressure groups were not slow to take up these issues and even the 'quality' newspapers devoted several pages to the 'horror stories' recounted by small business owners. Now that the media interest in the issue has diminished, it has become obvious that the main cause of the large increases in small business failures was the recessionary impact of the government's high interest rate monetary policy. Although the Cowling et al (1991) and Binks et al (1992) studies were critical of the banks on some counts, both reached similar conclusions.

In reply to the accusation of abusing their monopoly power by increasing their margins on small firm lending precisely when firms were most financially vulnerable, the banks have argued that this simply reflects their increased monitoring costs and greater exposure to business risk in economic downturns. The recently published evidence from surveys of small business owners (Cowling et al, 1991 and Binks et al, 1992), however, indicate that most small firms pay interest rates only

some 2-4 percent above base rates and that bank margins on small firm lending have increased only marginally as the recession deepened. Perhaps the major source of recent concern has been the perception that a significant number of small firms have failed because the banks were too ready to call in the receivers whenever any hint of financial problems came to light. These concerns were inevitably fuelled during 1991 and 1992 by the downturn in macroeconomic activity because, as Chrystal (1992) has noted:

“Money lenders have had a bad press in recessions ever since Biblical times. In this regard, banks do not cause the problem—rather it is the inevitable outcome of a business downturn. The bank simply conveys the news that negative cash flow cannot go on for ever.”

It could be argued that the banks' concern with protecting the security of their investments merely reflects the nature of the debt contract—lenders do not share in upside potential and, therefore, do not expect to bear any uncompensated downside risks. However, it needs to be emphasized that it is the concentrated structure of banking within the UK that has allowed the banks to compete via an increased provision of relatively safe overdraft finance rather than longer terms loans or hybrid sources of finance. In other words, some of the responsibility for the recent financial problems facing the small firm sector must lay with the relatively indiscriminate expansion of small firm funding via overdraft financing. The costs incurred by the banks themselves over the recent recession from small firm failures has led to pronouncements that future funding will be more cognizant of the specific characteristics of individual loans.

None the less, it would be unfair to see the relationships between small firms and banks being driven purely from side of the banks. Perhaps the only method by which conflicts between small firms and banks could be reduced would be if small firms secured more external equity finance. There is, of course, no guarantee that if equity risk capital were made available via the market that the contractual arrangements with small businesses would be any more agreeable to them. Indeed, part of the apparent conflict between small firms and banks in the UK exists precisely because small firm owners are unwilling to bind themselves to agreements that require them to share control and upside gains with external equity suppliers. This certainly appears to be the case judging by the highly negative attitudes expressed by small business owner-managers towards the possibility of equity holdings by banks (see Cowling et al., 1991).

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