Chapter 5
The Qualitative Relationship Between Banks and SMEs in Wales

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ABSTRACT

A long-term or close and intense relationship with banks could help overcome the main problems like asymmetric information. Using collateral is another way to overcome the effects of asymmetric information. The findings show that having collateral does not reduce loan costs, and on the other hand it will increase the availability of finance for small businesses. In general, small businesses use pecking order theory in choosing their formal sources of finance. Because of their lack of knowledge, they are not completely aware of available sources of finance. Banks are the first and most important external finance provider for small businesses, so having a good long-term relationship with banks can help them to overcome problems like asymmetric information, which would influence their access to more finance. Collateral is the other way to access more finance and it can help small businesses in their relationship with banks, especially in a period of unsustainability to reduce the risks for banks.

INTRODUCTION

The importance of a healthy and growing Small and Medium Enterprise (SME) sector for the stability, development and success of an economy and financial sector in developed and developing countries is well documented in specialist literature. The main problem in the growth of a healthy and developing SME sector is 'accessing finance' for start-up, growth and survival.

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In the UK, over the last two decades, the number of Small and Medium Enterprises (SMEs) has increased rapidly, for both white-owned and ethnic minority owned businesses. The small business sector has played an important role in socio-economic infrastructure and local and regional regeneration, as well as contributing towards employment, social welfare and inclusion (Deakins *et al.*, 2001; Hussain and Matlay, 2007a; Blackburn and Ram, 2004; Stanworth and Purdy, 2004). After the early 1990's recession in the UK, the importance of a growing and sustainable SME sector became more crucial for ongoing growth, development and success of the economy and financial sector. Considerable academic research and debates highlight different obstacles and limitations faced by SMEs in developing and developed countries. For example, a different legal framework and regulatory environment confronting them, lack of access to suitable and relevant information and even advice, the acquisition of skills and managerial advice, and even a lack of entrepreneurial skills, problems relating to market access, etc (Nigrini and Schoombee, 2002). One of the main problems, that several studies have highlighted, in the growth and development of SMEs, regardless of their size, are difficulties in accessing finance and other related financial issues; for starting-up, extending the business or even financing along their life time (Pissarides, 1999; Tucker and Lean, 2003; Westhead and Wright, 2000; Storey, 1994).

There are several individual and organisational factors like size, growth, asset structure, profitability and risk, which influence the size and availability of different sources of finance for small businesses (Cassar and Holmes, 2003; Tucker and Lean, 2001, 2003; Timmons, 1997). Accessing the appropriate finance for SMEs is essential for starting-up or growing their businesses (Reynolds and Lancaster, 2006). While some small businesses have accessed short-term finance, they have encountered problems in accessing long-term finance to support and raise their working capital (Bank of England, 1999; Tucker and Lean, 2001).

In developed and developing countries, banks and other financial institutions are recognised to be an important source of finance for most small businesses. In the UK, most of the small businesses have approached banks either for bank loans or a facility for seeking finance (Binks and Ennew, 1996, 1997; Berger and Udell, 2002; Cosh et al., 1996; Cruickshank, 2000; CBR, 2000; Chami, 2001). Research has shown that bank loans appear to represent the first choice in seeking external finance for small businesses.

Difficulties in obtaining bank loans have been recognised as a major constraint for the development of small and medium businesses in developed and developing countries (Keasey and Watson, 1994; Levy, 1993). In the UK, some small businesses have faced financial difficulties for starting-up. Especially those without appropriate loan collaterals and lacking a financial track record face considerable difficulties in accessing the necessary finance to grow and/or survive (Hussain and Matlay, 2007a).

Within the SME sector, Ethnic Minority Businesses (EMBs) have grown significantly during the last two decades. In England and Wales during the 2000 and 2004 period, the start-up of small EMBs increased significantly by 56% to over 250,000 businesses (Mascarenhas-Keyes, 2006). Research studies have argued that there are considerable differences between white-owned and ethnic minority owned businesses in financial constraints (Smallbone et al., 2003; Bank of England 1994, 1999 and 2001).

Therefore this research investigates the financing preferences of both white and ethnic minority owned businesses, examines their access to both formal and informal sources of finance, and their relationship with banks, and compares them to show their differences.

Accessing finance has been recognised as one of the key obstacles in the growth and development of small businesses, therefore this research investigates the financing preferences of both white and ethnic minority owned businesses, and examines their access to both formal and informal sources of finance.