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Business collateral and personal commitments in SME lending

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Abstract

Using a database of SME credit approvals from a large Belgian bank, this paper extends the empirical evidence on the determinants of collateral by examining the determinants of business collateral simultaneously with the determinants of personal collateral/commitments. Our results suggest that firm and relationship characteristics seem to be more important determinants of collateral/commitment protection than loan and lender characteristics. Family firms are more likely to offer a higher degree of collateral/commitment protection while introducing competition between banks decreases this likelihood. The collateral requirement decreases in the length of the bank-borrower relationship. Furthermore, trade credit seems to have a signalling effect. The 'lazy banks hypothesis' was not supported. Our results suggest that beside risk arguments, also commercial arguments help explain the pledging of collateral. Using a continuation-ratio logit model, we discover several differences in the determinants of the collateralisation decision and the determinants of the type of collateral/commitments.
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1. Introduction

The use of collateral is a common feature of credit contracts between firms and lenders. The question why the use of collateral is so widespread has been the subject of several theoretical contributions. In general, the contractual relationship between borrowers and lenders may be hampered by the presence of asymmetric information, adverse selection and moral hazard, usually leading to credit rationing. As such, the risk of lending may be reduced by collateral. Collateral may play the role of a signalling device for borrower quality (e.g. Chan and Kanatas, 1985; Bester, 1985; Besanko and Thakor, 1987a,b; Boot et al., 1991), may lower the agency costs of debt by preventing the problem of asset substitution (Jensen and Meckling, 1976) and mitigate Myers' (1977) underinvestment problem (Stulz and Johnson, 1985). In general, when moral hazard risk shows up in the lending relationship, collateral may play a disciplinary role in the behaviour of the borrower. Consequently, stronger creditor protection from collateral would lead to better credit terms or even the approval of credit that otherwise would not be granted. According to Mann (1997a,b), secured credit limits the firms' ability to obtain future loans from other lenders or reduces the risk of excessive future borrowing.

Recently, Manove et al. (2001) criticized the unrestricted reliance on collateral and argued that this might have a negative impact on credit-market efficiency. They argue that banks are in a good position to evaluate the future prospects of new investment projects. Collateral will weaken the bank's incentives to do so. Especially for small firms, banks would do little screening and rely excessively on collateral. From the point of view of banks, collateral and screening can be considered as substitutes.

Despite the considerable amount of effort that has been devoted in the theoretical literature to the role of collateral in business lending, only few theoretical studies (e.g. Chan and Kanatas, 1985; Mann, 1997b) make the explicit distinction between personal and business collateral. Chan and Kanatas (1985) postulate that business and personal collateral are very similar. Nevertheless, Mann (1997b) argues that personal collateral is more effective in limiting the borrower's risk preference incentives by enhancing the likelihood that the principal will feel any losses personally.

The empirical literature (Leeth and Scott, 1989; Ang et al., 1995; Avery et al., 1998; Harhoff and Körting, 1998; Degryse and Van Cayseele, 2000; Hanley, 2002) concerning the determinants of collateral is rather scant, partly due to data limitations. While it is well documented that small and medium-sized firms rely primarily on financial intermediaries as lenders, especially commercial banks (Cole et al., 1996), only partial clues exist as to the role of personal wealth or business wealth in the contractual details of lending arrangements. To date, as far as we are aware off, only two empirical studies (Ang et al., 1995; Avery et al., 1998) examine the topic. Both studies found that personal commitments are an important component of SME lending. However, no efforts have been made to refine such results by distinguishing the factors related to both personal commitments[1] and business collateral usage. Moreover, no European empirical evidence is available to date.

This paper contributes to the literature in two ways. First, using a recent database of a large Belgian bank, new empirical evidence on the determinants of both types of collateral

[1] Personal commitments are defined as both personal collateral and guarantees that make owners personally liable for business debt (cfr. Avery et al., 1998).

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