# On the Existence of Relationship Lending in Islamic Microfinancing

Wildan Syahid and Zuliani Dalimunthe
*Faculty of Economics and Business, Universitas Indonesia, Depok, Indonesia*
*zuliani_d@ui.ac.id, zulianifeui89@gmail.com*

Keywords: Relationship Lending, Islamic Microfinance, Indonesian Cooperatives, Wilcoxon Sign-rank Test.

Abstract: Relationship lending is an innovation measure to reduce credit constraint to micro firms. It refers to a process to build a robust and long-term relationship between financier and entrepreneurs by putting more trust in the prior relationship compared with the traditional financing process. This research aims to examine the existence of relationship lending in Islamic microfinance institutions in Indonesia and how it will affect the financing terms. This research is conducted using surveys of Islamic microfinancing institutions in 2017, which consist of Islamic cooperatives, BMTs, and Islamic rural banks. We found that relationship lending exists in the funding process of Islamic microfinancing institutions. Islamic micro finance tends to rely on a long-term friendly relationship to collect soft information regarding the development of the business as well as trustworthiness of entrepreneurs. Using Wilcoxon signed-rank test, the results show a positive difference in the maximum financing provided and a negative difference in the length of processing time if the credit officer knows the entrepreneur as well as his or her relatives. However, findings regarding terms of the collateral requirement are not conclusive.

## 1 INTRODUCTION

Development of micro and small enterprises has become a crucial government policy around the world, both in developing countries or developed countries. Micro financing has become the most important measure to alleviate poverty, especially in developing countries. Torre et al. (2010) stated that the rising attention to micro and small enterprises development because of this sector is covering a large part of business unit in a country and provide the biggest part of employment opportunity. Moreover, many of big corporations in developed countires were come from small or medium firms. In Indonesia, the ministry of cooperatives and SME's report of year 2012 shows that there more than 56 million or 99% of business units categorized as micro and small firms. Moreover, these sectors provide more than 107 million jobs or about 93% employment opportunity in Indonesia.

The development of micro and small firms needs a strong financial support to survive and to expand their business scale. However, commercial banks reluctant to provide funds for these sectors. Micro and small firms contain high information asymmetric thus formal financial institution difficult to assess whether the firm has enough capacity to repay the loan or whether the entrepreneur has enough willingness to make the repayment as promised (Torre et al., 2010).

Credit constraint in micro and small firm has become major concern among scholars and policy makers as well. Many measures have been taken to reduce this credit constraint. One of them is relationship lending. A large body of literature proposed several variables to characterize relationship lending. The relationship lending refers to a process to build a strong and long term relationship between the financier and the entrepreneur or borrower. Relationship process generate valuable soft information regarding the business and the entrepreneurs in asymmetric information environment. The relationship will then increase trust in the financing evaluation. This effort conducted with many ways such as making communications to family members and other people in community. This soft information is useful to reduce information asymmetric regarding viability of the business and the character/ trustworthiness of the entrepreneur (Petersen and Rajan, 1994; Berger and Udell, 1995; Boot, 2000; Elyasiani and Goldberg, 2004; Ogura, 2009).

Poverty alleviation is an important priority in Islamic finance. In every wealth of the rich there is the right of the poor to be expelled through zakat.



Syahid, W. and Dalimunthe, Z.
On the Existence of Relationship Lending in Islamic Microfinancing.
In *Proceedings of the 1st International Conference on Islamic Economics, Business, and Philanthropy (ICIEBP 2017) - Transforming Islamic Economy and Societies*, pages 751-755
ISBN: 978-989-758-315-5

There is also a recommendation to pay for *waqaf*, *infaq* and *sadaqah* who get good rewards in the afterlife. These funds are Islamic social funds that should be used as source of microfinancing. Islamic micro finance funds commonly channeled through Islamic micro financial institutions (IMFs) known as house of charity (*baitul maal wattamwil*, BMT) or Islamic cooperatives. Today there are thousands of BMTs and Islamic cooperatives in Indonesia. Besides BMT and Islamic cooperatives, rural banks (*bank perkreditan rakyat syariah*, BPRS) is other institution that provide financing for micro and small firm.

This research aims to evaluate the existence of relationship lending in financing process of Islamic microfinancing institutions (IMFs). Specifically, the research is to evaluate the strength of the relationship between Islamic microfinance institutions (IMFs) with entrepreneurs as their borrowers and how that relationship effect to the access and terms of financing. Relationship lending has become an innovative way to provide micro financing and become more reliable information along with the strength of the relationship itself ( Petersen and Rajan, 1994; Berger and Udell, 1995; Boot, 2000). However, there is only few research regarding relationship lending in Indonesia, while relationship lending in Islamic microfinancing institutions (IMFs) is even more rare. This research contributes to fill the gap.

The paper is structured as follow. Section 2 describe literature review of relationship lending topics and role of Islamic microfinance in Indonesia. Section 3 describes methods employed to evaluate hypothesis proposed here. Section 4 consist of discussion and analysis section while section 5 provide conclusion of the research.

## 2 LITERATURE REVIEW

Berger and Udell (2006) highlight the importance of micro, small and medium enterprises' financing for economic growth of a country, including the United States. However, financing for this sector subject to high asymmetric information involved. Micro and small sectors commonly characterized by the lack of reliable hard information. They rarely provide regular financial report, even in unaudited form. Thus, there are severe credit constraint in this sector.

Limited hard information in micro and small-scale firm drive lending institutions to rely on much private and soft information to make financing approval decision. There are several ways to obtain this soft information, but one method that is especially well suited for opaque firms is to develop a long-term relationship between lender and borrower. This commonly known as relationship lending or relationship financing (Peterson and Rajan, 1994; Berger and Udell, 2002). Relationship lending based on theory that a relational long term contract allows the lender to implicitly apply incentive contracts between the times. It means that the successful repayment of a financing with higher interest rates will be compensated by cheaper and easier financing in the next period (Berger and Udell, 2002). This argument means that long-term relationships between lenders with borrowers will increase the chances of credit availability for both new businesses and the existing ones. Reduction in the financing cost is driven by the reduction of information asymmetric through acquisition of many relevant "soft" information. Elyasiani and Goldberg (2004) stated that the continuous contact between borrower and lender in the provision of various financial services can produce valuable input for the lender in making decisions on whether to extend credit, how to price loans, and whether to require collateral or attach other conditions to the loan.

Relationship lending becomes an important financing mechanism in SMEs financing to overcome credit constraints in this sector. Petersen and Rajan (1994) conducted an empirical study of 3,404 small businesses in the US which are not evaluated by the rating agencies, how the relationship between creditor and entrepreneur would imply to the availability of loan and the cost of the loans. It found that the strong relationship has the positive effect on the availability of financing although its impact on business capital cost reduction was not significant. Ogura (2009) in his study in Japan support the idea that the found the higher loan cost available for younger firms compared to older ones. Also, Lopez-Espinoza et al. (2017) show that firms begin to capitalize the gains of relationship lending when the relationship extends beyond two years and that relationship lending significantly mitigates the increased costs of re-financing loans.

A study conducted by Behr et al. (2011) analyze whether the closeness of the relationship between the lender and the borrower would overcome asymmetric information problem in SMEs sector. They examine how this closeness imply to the availability of loan as well as the term of the contract. This study took place in Mozambique using data from 2000 to 2006. Meanwhile, Behr et al. (2011) analyzed how the impact of the intensity of the relationship between the microlender and the borrower. It concluded that the intensity of the lender-borrower relationship positively implies to: (a) the higher access to loan, (b) the shorter of loan processing time, (c) the more lenient terms of collateral. While from macro perspectives, Egli et al. (2006) found that the relationship lending is a mechanism which is superior in an economy when the chances of default are quite high due to the financial system which has not developed as characterized by low transparency and weak legal enforcement.

# 3 METHODOLOGY

Population in this research is Islamic micro finance institutions (IMFs) consist of houses of charity (known as *baitul maal wattamwil* or BMTs), Islamic cooperatives, and Islamic rural banks (*bank perkreditan rakyat syariah* or BPRS). We used primary data generated from semi-close questionnaire, mixing a close questionnaire with direct interview to generate more understanding about variable evaluated.

The measurement of relationship lending variables here adjusted from Behr et al. (2011) and Serrano-Cinca et al. (2016). The adjustment made to get more appropriate measurement according to Indonesians habit and culture. Relationship lending here measured as (a) whether the credit officer knew the prospective borrower previously or not, (b) whether the credit officer knew the prospective borrower's relatives previously or not (c) whether the prospective borrower had borrowing records before. Meanwhile, financing terms as dependent variables in this study are (a) the maximum financing the IMFs ready to provide, (b) the length of processing time for each loan application, and (c) the terms of collateral required.

We divided maximum financing ready to provide into five categories, length of processing time into four categories and terms of collateral required into three categories. Categories of maximum financing ready to provide are (i) Rp 1.000.000, (ii) Rp 5.000.000, (iii) Rp 10.000.000, (iv) Rp 20.000.000 and (v) above Rp 20.000.000. Categories of processing time are (i) one day, (ii) 2-5 days, (iii) 5-14 days and (iv) more than 14 days. And categories of terms of collateral are (i) loose terms when the borrower only provide copy of motorcycle ownership document, (ii) medium terms when the borrower required to provide authentic motorcycle of car ownership documents and (iii) tight terms when the borrower required to provide authentic house document ownership.

Furthermore, the categories of each independent variable divided into three parts. In the first variable, maximum financing IMFs ready to provide divided into (a) higher, (b) indifferent and (c) lower. Higher category defined as higher maximum financing the IMFs ready to provide if any condition of relationship lending applied, and vice versa. In the second variable, the length of processing time divided into (a) longer, (b) indifferent and (c) shorter. Shorten category defined as when the IMFs process a loan application in shorten time when relationship lending applied, and vice versa. While in the third variable, terms of collateral required, divided into three namely (a) tighter, (b) indifferent and (c) looser. For analysis, we used Wilcoxon sign rank test to examine whether an IMF move from one into another category of each variables (maximum loan ready to provide, processing time and terms of collateral) when relationship lending applied.

# 4 DISCUSSION AND ANALYSIS

The survey and interview conducted in 30 IMFs located in several cities in Indonesia. The data consist of 44% BMT, 33% Islamic cooperatives and 23% Islamic rural banks. Summary of the Wilcoxon sign rank test presented in table 1.

Table 1: Summary of Wilcoxon Sign Rank Test.

| Maximum financing | Move to higher category (p-value) | |
|---|---|---|
| Knew borrower previously | 0.0016 | *) |
| Knew borrower's relatives | 0.0047 | *) |
| Having track record in IMF | 0.0048 | *) |
| | | |
| Processing time | Move to shorten time category (p-value) | |
| Knew borrower previously | 0.0001 | *) |
| Knew borrower's relatives | 0.0016 | *) |
| Having track record in IMF | 0.0001 | *) |
| | | |
| Terms of collateral | Move to looser category (p-value) | |
| Knew borrower previously | 0.1573 | |
| Knew borrower's relatives | 0.0047 | *) |
| Having track record in IMF | 0.0047 | *) |
| | | |
| *) sig at 5% | | |

## 4.1 Maximum Financing Ready to Provide

The first variable evaluated in this study is the maximum value of financing provided. In average, financing provided are in the range of Rp 2 million - Rap 10 million with repayment term of less than one year. Very little financing given in amounts above Rp 10 million. Perhaps, this term relates to the access for financing provided by Indonesian commercial banks commonly at the minimum amount of Rp 10 million.

Table 1 shows that most respondents acknowledge that they are willing to provide higher financing if the borrower has personally known in advance or if the credit officer/significant person knew the relatives of the borrower previously. From the same data also found that IMFs are willing to provide higher amount of financing if the borrower had track record on the IMF. The Wilcoxon sign rank test shows that relationship lending positively affects access to higher financing.

### 4.2 Length of Processing Time Of Loan Application

The following variable evaluated are the loan application processing period. On average, the average processing time is in the range of 5-14 days in BMT and 2-5 days at BPRS and cooperative. Among the three types of IMF in this study, the cooperative has the shortest processing time compared to BMT and BPRS, with the most processing time on one day and 2-5 days. An interesting finding is that only cooperatives under any circumstances can process the financing application within a day. Moreover, the processing was sometimes only done through short messages or phones communication while handing the administrative requirements done in conjunction with the financing signatories. Even for customers that had a good track record, the cooperatives sometimes 'picked up the ball' by initiating to offer the new financing or offered new financing before the maturity of the last payment of the existing financing. Thus, there is a sustainability for financing.

### 4.3 Terms of Collateral Required

The third financing variable, the collateral requirement, appears different pattern. There is insufficient evidence that the terms of collateral are more lenient when the credit officer knows the borrower previously. However, when a credit officer knows the relative of the borrower or the borrower has a track record on the BMT then the terms of the collateral become more lenient significantly. Our guess that the type of IMFs affects the type of collateral requirement in which BPRS tends to require strict collaterals while Islamic cooperatives and BMTs require more loose collateral. The type of engagement conducted on collaterals at BMT or cooperatives put in the form of sealed agreement, without notarial deed. By law, this agreement is very difficult to execute transfer of ownership of the asset in case of default.

## 5 CONCLUSIONS

This study shows that relationship lending exists in the financing process at IMFs in Indonesia. The officers acquainted to potential borrowers and their families or relatives. Any information generated from the relationship becomes an important factor for making financing decisions. IMFs are significantly willing to provide higher amount of financing when the borrower has known by the officer previously or when the officer knows the borrower's relatives as well as that the borrower had previous records on the IMFs. The closeness of this relationship also effects to shorten length of approval processing time. It means that IMFs will process financing faster when the the IMFs officers knew the borrower or knew the borrower's relative previously. However, the closeness of this relationship results in an inconclusive finding regarding the terms of collateral requirement. There is no sufficient evidence to conclude that the collateral requirement becomes more lenient when the relationship become stronger. The terms of the collateral requirement are significantly looser when the officer knows the entrepreneur's relatives, but not if the officer knows the entrepreneur itself. This finding needs rational explanation. Also, if the sample study is larger, this conclusion might be different. Future research is needed to answer this.

## ACKNOWLEDGEMENTS

We are grateful to the University of Indonesia that has funded this research through the PITTA grant in 2017. Also to all those who contribute so that this research able to accomplish.

## REFERENCES

Behr, P., Entzian, A., Guttler, A., 2011. How do Lending Relationship Affect Access to Credit and Loan Conditions in Microlending? *Journal of Banking and Finance*. 35, pp. 2169-2178.

Berger, A. N., Udell, G. F., 1995. Relationship Lending and Lines of Credit in Small firm Finance. *Journal of Business*. 68, 351-382.

Berger, A. N., Udell, G. F., 2002. Small Business Credit Availability and Relationship Lending: The Importance of Bank Organisational Structure. *Economic Journal*. 112, 32-53.

Berger, A. N., Udell, G. F., 2006. A more Complete Conceptual Framework for SME Finance. *Journal of Banking and Finance*. 30, 2945-2966.

Boot, A. W. A., 2000. Relationship Banking: What Do We Know? *Journal of Financial Intermediation*. 9, 7-25.

Egli, D., Ongena, S., Smith, D. C., 2006. On the Sequencing of Projects, Reputation Building and Relationship Finance. *Finance Research Letters*. Vol.3, 23-39.

Elyasiani, E., Goldberg, L. L., 2004. Relationship lending: a survey of the literature. *Journal of Economics and Business*. 56, 3114-330.

López-Espinosa, G., Mayordomo, S., Moreno, A., 2017. When does relationship start to pay? *J. Finan. Intermediaton*. 31, 16-29.

Ogura, Y., 2009. Lending Competition and Credit Availability for New Firms: Empirical Study with the Price Cost Margin in Regional Loan Markets. *Journal of Banking and Finance*. 36, 1822-1838.

Petersen, M. A., Rajan, R. G., 1994. The Benefit of Lending Relationships: Evidence from Small Business Data. *The Journal of Finance*. Vol. XLIX No.1.

Serrano-Cinca, C., Gutiérrez-Nieto, B., Reyes, N. M., 2016. A social and environmental approach to microfinance credit scoring. *Journal of Cleaner Production*. 112, 3504-3513.

Torre, A., Pería, M. S. M., Schmukler, S. L., 2010. Bank involvement with SMEs: Beyond Relationship Lending. *Journal of Banking& Finance*. 3, 2280–2293.