

The Entrepreneur and the Banker: A Comparative Study of Factors Affecting the Relationship

Principal Topics

The entrepreneur and the banker are clearly in an interdependent relationship—the banker is the primary provider of debt capital to smaller firms and the entrepreneur is a major source of business for banks. If one loses, they both lose. From an economic perspective, the key determinant of the relationship between the banker and the owner of a small and young entrepreneurial firm is the sharing of cash and risk. In this regard, there are three central issues. (1) information asymmetry between the lender/investor and the entrepreneur, (2) moral hazard, and (3) the possibility of a young firm not caring about its reputation in the early years.

The banker has two avenues for minimizing the foregoing risks: (1) structuring the loan to reduce the likelihood that the entrepreneur will make decisions that negatively impact the lender, and (2) maintaining an on-going relationship for the purpose of monitoring the entrepreneur's performance. Both of these activities deal with the processes used to accomplish the desired results, and equally important, to enhance the effectiveness of the communications between the banker and the small-firm borrower.

This study provides a comparison of perceptions and expectations between bankers and small-business owners regarding the following matters: (1) the existence of philosophical differences, (2) the perceived effectiveness of the relationship, (3) the variables used in assessing the riskiness of a loan, (4) criteria used in making a loan, and (5) the use of loan covenants.

Method

The research methodology for this study involved three stages. First, we reviewed the relevant literature appearing in practitioner banking journals and examined documentation used by bankers in structuring loans as well as training literature for new lenders. We then conducted in-depth interviews of bankers and entrepreneurs of small- and mid-sized firms for the purpose of identifying the key issues as perceived by both groups. These interviews provided the basis for an extensive four-page survey instrument developed for use with an initial group of ten entrepreneurs and 15 bankers. We next mailed the questionnaire to a random sample of companies (drawn from the Dun & Bradstreet data base for firms with sales between \$5 and \$50 million and Inc. 500 firms) and lenders (also taken from the Dun & Bradstreet data base). In response to the mailing, we received completed questionnaires from 40 entrepreneurs and 56 bankers, which represented an overall response rate of only six percent. Owing to the low response rate, which should be no great surprise given the length of the survey instrument, we have based our research findings on the combination of the in-depth interviews and the questionnaire results. In this regard, the findings proved consistent across both groups, which gives some increased validity to the overall conclusions.

Major Findings

The findings suggest that bankers and entrepreneurs do in fact see the world of business similarly in some ways, but noticeably different in others. Some of the key findings of the study include the following:

When it comes to the level of effectiveness in the relationship, bankers perceive the relationship more positively than do the business owners.

Practically all the bankers (92%) compared to one-half of the entrepreneurs believe that bankers add value beyond providing the money. Also, almost all the bankers (96%) feel a

- commitment to help a firm achieve its financial goals beyond providing the requested
- financing. In contrast, 63 percent of the entrepreneurs believe their banker has such an interest.

Entrepreneurs view the banker as too interested in the financial numbers and not enough in

- understanding the business.
- The keys to an effective relationship, as perceived by entrepreneur and banker alike, are: (1) the need for open communications, (2) the importance of mutual respect and trust, and (3) the banker's commitment to work with the firm if problems develop for the borrower.
- Bankers are reluctant to make a loan to a new firm, particularly a startup where the repayment of the loan primarily depends on the success of the business.
- When it comes to the banker assessing risk, entrepreneurs as a group have no consensus on which issue is of more importance than another. However, when it comes to the bankers, the conclusion is clear—character and cash flow are of primary importance.

Ninety-six percent of the bankers consider personal guarantees as required either most of the time or always. There is also an equally strong preference on the part of the entrepreneur to avoid personal guarantees.

Implications

The purpose of this research is to come to a better understanding of the on-going relationship between the banker and the entrepreneur. As a primary provider of capital to smaller companies, there is a great need for an increased understanding and appreciation for the perspectives of each group. To date, we have little more than anecdotal evidence of this relationship. There is much more that needs to be done.