



Retail Business Owners Preference: Why not Formal Financing?

Athar Iqbal and Bilal Hamid*

ABSTRACT

Finance is a basic need to run a business and the need of external financing is also required during the business cycle, expansion, growth etc. In this research, Retail Business Owners (RBO's) were being questioned to find out the reasons for their preference on informal financing rather on formal financing. Karachi was the sample population to investigate the rationale of this research. Test of Proportion and Test of Association found that low interest rate, religious restriction and documentation are the major reason for preferring informal financing over formal financing.

Keywords: Retail business, Small business, financing choice, informal financing, formal financing, bank financing

JEL Classification: D14, G24, R51

Introduction

Doing business is not easy anywhere in the world. To run a business successfully funds are the basic and important part of it. Arrangements of finance are difficult always and nowadays it becomes more difficult and problematic to arrange funds for running a business, to arrange one, owner usually contacts financial institutions to help them out. In the third world countries where literacy rate is not good enough people don't know how to deal with banks and credit providers so they use the alternative ways to arrange the finances for their businesses such as they borrow it from known persons, friends and relatives (Curan & Blackburn, 1993). According to Bates (1997) in Asian market family borrowing is high in ratio and frequent as compare to bank borrowing. Obtaining loan from bank is difficult and time taking process anywhere in the world for business purposes especially. According to Berger and Udell (1995) that relationship is the most important part to take credit facility from banks. In Pakistan taking loan is a difficult task, relationship matters and the religious views at times matter the most. There are two types of lender available in market; first, formal lenders who abide by the government laws and policies for lending like banks and other financial institutions, secondly informal lenders who do not come under government laws and regulations they are like lending within families, friend, business partners, and individual lenders.

* Corresponding author's email: athar@iqra.edu.pk and mbilalhamid@gmail.com

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It is observed that country like India, Pakistan, Bangladesh, Indonesia and Malaysia have a large number of group of business men who do not prefer extra funding from banks, they usually prefer other sources to finance and full fill their needs in business.

In Pakistan other than banks there are several types of financing which people use for the fulfillment of extra funds to run their businesses. These types of financing are divided into two main categories i.e. Formal financing and Informal financing. Usually RBO's use to borrow from their relatives, individual lenders, friends and some use to take it from their reserves. Our main concern in this research is to find out the reasons due to which RBO's do not prefer taking loan from banks or formal financing, while fulfilling this research objective their way of funding is also determined during research.

Literature Review

Chakrabarti and Qian (2006) found official external financing for small businesses has been overwhelmed by non-market sources of funds in India, while listed companies to behave more like those from countries with poor protection financiers.

Berger and Udell (1995) found that there is no significant impact of the duration in lending relationship and cost of borrowing.

Petersen and Rajan (1994, 1995) found that small businesses have relationship for borrowing other than financial institutions and they have to pay low price of borrowing to other sources.

The entrepreneur in Britain coming from South Asia usually arranges their financing among themselves by borrowing from their country hood or relatives. As they were use to financing the same way in their homeland as well so they prefer the same method of financing in Britain as well (Basu & Goswami, 1999).

Cavalluzzo and Wolke (2005) found that large and medium businesses use to finance small businesses from their reserves, their limit is approximately 30% of their reserves for financing and these financing are totally based on relationship and is available on the low rates as compare to rate of borrowing from financial institutes (banks). A large firm uses their wealth in funding small firms on relationship. Basu (1998) stressed that Britain prefers South Asian as a retail entrepreneur as they use their capital in small business mostly in retail stores and they use to finance themselves among their community and through their relationship so government has lesser risk of loss.

Berger and Udell (1998) advocate a complementary concept for explaining small businesses capital structure. In their framework small businesses are viewed through a financial development cycle model where unlike capital formation are most favorable at different point of cycle, mostly of them rely on internal sources of funding in their early years of operation and after by the time when they grow they look for partnership or funding from informal sources such as relatives, friends and private lenders. In terms of financing sources, Ou and Haynes (2003) studied that internal equity as opposed to external equity is the main source of financing for RBO's. Most RBO's rely on internal sources of funding and they avoid external debt to finance their businesses. According to Mason and Harrison (1999) uncertainty surrounds the demand for small business financing there is more confidence regarding our understanding of the supply. As mentioned by Zacharakis and Shepherd (2001) over the past decades there have been a growth in interest rates for equity financing.

Irfan and Ali (1999) explained that Pakistani credit market, as in other emergent countries are characterized by the co-existence of semi formal, formal and informal loan providers. Informal loan providers include a wide assortment of lenders in area including friends and relatives. Semi formal institutions are non government organizations and other micro financing institutions, both formal and semi formal contribute to a very small number of shares in small business credit markets. As by Nabi, Qureshi, and Faruqee (1996) the 1985

credit survey indicates that only 10 percent of borrowing domestic borrows from formal sources and roughly 1 percent from semi formal sources.

Madestam (2009) stated that common characteristic of credit markets with weak legal institutions is coexistence of formal and informal financial sector. Informal business like loans made by money lenders, family members, friends, traders and land lords for almost one third or three quarters of total loan in Asia. In India about 70.1 percent of all entrepreneurs attain finance from both sectors at the same time. Moreover, informal financiers who offer loan frequently acquire formal resources to service entrepreneurs financing needs with formal loan totaling two third of the informal sector liabilities in several Asian countries.

Hypotheses

Following hypotheses have been developed to interrogate the objective of this research:

- H1:** Borrower equally prefers taking loan from bank and other resources.
- H2:** Borrower equally is aware of loan facilities provided by banks.
- H3:** Borrower equally is aware of conditions on which banks provide loan.
- H4:** Borrower equally is aware of cost of borrowing from banks.
- H5:** Religious point of view is independent with the choice of source i.e. Banks and Others.
- H6:** Documentation is independent with the choice of source i.e. Banks and Others.
- H7:** High interest rate is independent with the choice of source i.e. Banks and Others.
- H8:** Time taking process is independent with the choice of source i.e. Banks and Others.
- H9:** Recollection process is independent with the choice of source i.e. Banks and Others.

Research Methods

Primary data is collected through personal visit to small business owners (RBOs') while interviewing them via various relevant questions.

Un-restricted non-probability sampling technique has been deployed to collect the sample of approximately 300 respondents from Karachi. To interrogate the sample data Test of Proportion and Test of Association are used.

Findings and Results

The first four hypotheses were tested by test of proportion, whereas, the last five hypotheses were tested by test of association as shown in the table 1 and 2.

Table 1: (Test of Proportion)

Hypotheses		Frequency	Percent	Valid Percent	Cumulative Percent	Z value
1	Bank	32	11.7	11.7	11.7	
	Other	242	88.3	88.3	100.0	
	Total	274	100.0	100.0		12.68
2						
2	No	118	43.1	43.1	43.1	
	Yes	156	56.9	56.9	100.0	
	Total	274	100.0	100.0		2.28
3						
3	No	134	48.9	48.9	48.9	
	Yes	140	51.1	51.1	100.0	
	Total	274	100.0	100.0		0.36

Hypotheses		Frequency	Percent	Valid Percent	Cumulative Percent	Z value
4	No	148	54	54	54	
	Yes	126	46	46	100.0	
	Total	274	100.0	100.0		1.32

The findings of this paper as highlighted in table 1, reveal that for all first four hypotheses, $Z > 1.5$ thus we fail to accept all first four hypotheses, which include Borrower equally prefers taking loan from bank and other resources, Borrower equally is aware of loan facilities provided by banks, Borrower equally is aware of conditions on which banks provide loan and Borrower equally is aware of cost of borrowing from banks.

Table 2: (Test of Association)

Hypotheses		No	Yes	Total	Chi Sq.	Sig.
5	Bank	18	14	32	4.3	.038**
	Other	90	152	242		
	Total	108	166	274		
6	Bank	17	15	32	5.477	.019**
	Other	177	65	242		
	Total	194	80	274		
7	Bank	22	10	32	1.135	0.287
	Other	187	55	242		
	Total	209	65	274		
8	Bank	26	6	32	.001	.972
	Other	196	46	242		
	Total	222	52	274		
9	Bank	30	2	32	9.686	.002*
	Other	162	80	242		
	Total	192	82	274		

*significant at 1% and **significant at 5%

The findings for rest of last five hypotheses reveal that Religious point of view, Documentation and Recollection process are significantly independent with the choice of source i.e. Banks and Others as $\text{sig} < 0.05$ hence we are failed to reject the H5, H6 and H9 as shown in table 2.

Conclusion

As already assessed in result section that borrowers do not equally prefer taking loan from bank and other resources, while, borrower is neither aware of loan facilities provided by banks nor borrower is aware of conditions on which banks provide loan and nor Borrower is aware of cost of borrowing from banks. Moreover, Religious point of view, Documentation and Recollection process are significantly independent with the choice of source i.e. Banks and Others but high interest rate and Time taking process are dependent with the choice of source i.e. Banks and Others.

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