

## **Supply Side Obstacles to Financing the Private Sector: Empirical Evidence from a Small Island Developing State**

*Parmendra Sharma and Neelesh Gounder*

### **Abstract**

In light of the positive growing finance–private sector–economic growth findings, this article examines, from a supply side perspective, obstacles to private sector financing in Fiji, a growth deprived, small island developing state in the Pacific region. A survey of 80 percent of formal financial institutions reveals that, contrary to popular belief, financing the private sector may not be a major problem. However, the prevalent relationship – lending practices, good profits and well-managed risks, together with moderate growth in private sector credit – also suggests that suppliers may be concentrating on a systematically selected small group of connected borrowers, resulting in the wider private sector, including many SMEs, being left out. Growth and development implications extend to developing economies across the Pacific.

**Keyword** Fiji, PICs, banks, financing obstacles, small island states.

## Supply Side Obstacles to Financing the Private Sector: Empirical Evidence from a Small Island Developing State

### 1.0 Introduction

Around the world, prompted by a growing body of evidence demonstrating a positive and strong finance–growth link<sup>1</sup>, development of financial sectors continues to receive considerable attention from researchers and policy-makers alike. Conceivably, one interest has been in identifying and enhancing factors that may lead to greater demand and supply for credit to the private sector, mainly through banking and stock market channels. Here, research has identified a number of macro-level determinants, including the prominent legal institutions (La Porta et al., 1997, 1998; Demirgüç-Kunt & Maksimovic, 1998; Beck et al., 2003) and others such as politics (Rajan & Zingales, 2003) and culture (Garretsen et al., 2004).

While these studies have advanced our understanding of obstacles to demand and supply of private sector credit across countries, implications for the Pacific's small, vulnerable economies (Pacific Islands Countries (PICs)) with lacklustre growth are only beginning to emerge, with an underlying message that solutions and policies applicable elsewhere may not necessarily be suitable for this region. For example, Sharma and Roca (2012) argue that the development of stock markets should be less pursued in the PICs since this component of the developed world's financial system model may not be appropriate for the region, indicating that financial sector development in the Pacific is likely to be synonymous with banking development. Indeed, as Sharma and Brimble (2011) show, in practice, the banking sector *is* more or less *the* financial sector in the region. On the development of the banking sector, in turn, Sharma and Nguyen (2010) demonstrate that the role of legal institutions may not be as prominent in this region as acclaimed elsewhere.

All this leads to the question of how the demand as well as the supply of bank credit to the private sector could be enhanced in the PICs, keeping in mind that solutions applicable elsewhere may not necessarily be appropriate for the region. With respect to bank credit in the region, 'relationship lending' remains by far the dominant form of financing – for firms of all sizes, SMEs as well as large (Sharma & Brimble 2011). With relationship lending, as opposed to arm's-length lending, 'soft' information gathered by the lender through a continuous process involving personalised and direct contact with the borrower and related environment is critical in mitigating opacity problems (e.g. Berger & Udell, 1998). Here too, studies have attempted to examine the influence of these traditionally embedded risk mitigating factors in the process of obtaining/granting external finance (Beck et al., 2005; Beck & Demirgüç-Kunt, 2006; Beck et al., 2008a; de la Torre et al., 2008). Again, related research on the PICs appears sparse.

This paper fills the void in the literature by attempting to understand systematically, in relation to private sector credit, the views of the *suppliers* of credit (banks and non-banks) regarding obstacles to private sector financing in Fiji, a Pacific Islands Country. (A separate research paper looks at the views of *demanders* (firms): Sharma & Gounder, 2012a.) Given that worldwide liberalisation

and deregulation processes have empowered suppliers to ‘choose’ their borrowers, it is critical to understand the ‘willingness’ of the financiers to advance credit, as much as it is important to understand the views of the fund-seeking firms. In this study, the overall private sector credit includes enterprise as well as household credit. Household credit is included since it has been shown to constitute a major part of the overall credit across countries with its prominence increasing in the overall credit volume (Beck et al., 2008b). The borrowers are also separated into *prospective* and *existing* groups. The analysis is based on opinions of professional and experienced lenders, including very senior management across various lending institutions, gathered by means of a structured interview questionnaire.

Results show that lending institutions in Fiji may not face major obstacles in financing the private sector; the results hold across institutions of different size, profit levels, capital base, and other criteria, as well as across prospective *and* existing, business and household borrowers. It may be noted that in addition to similar socioeconomic and geopolitical circumstances, the PICs economies share similar financial institutions as well – for example major banks prevail across the region. However, lenders not necessarily, at the same time, be too keen in the wider private sector. Prevalent relationship lending practices, high profits and well-managed risks, together with moderate growth in private sector credit, indicate that revenues might be generated significantly from a relatively small group of interconnected borrowers and other non-credit sources. From the finance–growth literature, the implications for growth and development appear considerable; if the wider community is indeed being left out, not only may opportunities for more and/or adequate growth be compromised but improvements, if any, to the overall socioeconomic profiles of individuals and the economy are likely to be marginal.

The paper proceeds as follows. After Section 2’s overview of the formal credit market in Fiji and the greater PIC region, section 3 discusses the methodology for data collection and section 4 the methodology for data analysis. The results on perceptions about *prospective* borrowers are presented in the fifth section, and about *existing* borrowers in the sixth. Implications of the results are discussed in the seventh section and section 8 concludes.

## **2.0 The credit market in the PICs: a brief overview**

Across the PICs, the main source of formal external credit for the private sector is banks; bond markets are infinitesimal and confined to government and statutory bodies, and where stock markets do exist – only in Fiji and Papua New Guinea – they are small and illiquid. In fact, in the case of Fiji, the larger of the two although it is a smaller country, the market is so small, illiquid and inefficient that Sharma and Roca (2012) believe that it may be a misfit in the country’s financial system model; accordingly, the authors recommend its gradual withdrawal from the system.

Moreover, banking activities are still highly traditional, confined mainly to deposit and lending activities; investment banking and venture capital are virtually non-existent. Further, ‘relationship lending’ is virtually the most prominent form of credit assessment and granting, but without the modern credit scoring methods. All things considered, for the majority of start-up, newly established and/or established firms, as well as for the household sector, banks may be the only

(or at least the primary) source of formal credit; arm's-length lending is virtually not an option for most firms at any stage of development or for the household, and relationship lending is the dominant form (e.g. ADB, 2001).

Consequently, across the PICs, from a formal external credit viewpoint, as Demirgüç-Kunt and Levine (2008) point out, a bank is likely to considerably arbitrate who can/cannot start/expand a business, who can/cannot purchase a car/home; essentially, who can/cannot attempt to realise his or her economic aspirations. More importantly, from a financial sector perspective, it is the banking sector that largely arbitrates the rate of economic growth and development in the region (Levine, 2005). In light of such a pivotal role of banks in the socioeconomic growth and development of the region, it is imperative to understand – from their point of view – what obstacles there are to financing the private sector.

### 3.0 The Survey

In designing the survey, we were mindful that while successful borrowers are likely to contribute to growth and development, a declined credit is a forgone opportunity. Thus, a lender's perception about *prospective* borrowers appears at least as important as that of *existing* borrowers. Accordingly, to understand lenders' perceptions regarding obstacles to financing the private sector in Fiji, we designed a survey questionnaire to examine the difficulties they experienced in lending to (a) **prospective business** borrowers; (b) **existing business** borrowers; (c) **prospective household** borrowers; and (d) **existing household** borrowers. (As required, Griffith University's Ethical clearance was sought; among other things, respondents were clearly informed about the confidentiality of data collected.) Thus, we had four groups of borrowers.

With respect to the deemed obstacles from a lender's perspective, we reviewed two main sources: (i) regulatory requirements in the country; and (ii) extant literature. Both sources revealed similar suggestions. In relation to regulatory requirements, operations of most lenders (especially licensed ones, see figure 1 and discussion below) in Fiji are subject to BIS-standard, Reserve Bank of Fiji (RBF) regulations, including policies and guidelines on capital adequacy and asset quality. The capital adequacy policy essentially requires that regulated institutions adhere to Basel Capital Adequacy Requirements<sup>2</sup>. Institutions are also encouraged to follow closely RBF's guidelines on 'Loan Classification and Provisioning for Impaired Assets'<sup>3</sup>, another adaptation of Basel Committee's recommendations, which sets rules and best-practice guidelines on credit risk-mitigating factors, among others.

The risk-mitigating factors, as cited also in the literature, (e.g. Beck et al., 2005; Gup & Kolari, 2005; Clauretie & Sirmans, 2010; Koch & MacDonald, 2010) include, *inter alia*, collateral, capital contribution, financial and other documents, loan repayment, compliance with terms and conditions, collateral repossession and legal issues. Collateral, for example, has been shown to overcome adverse selection and moral hazard problems in credit markets. An important determiner of the availability and terms of credit is the ability of the lender to recover and sell collateral effectively. Thus, we examine whether obtaining adequate collateral constitutes an obstacle to financing. Similarly, paperwork (financial and other documents) constitutes transaction costs for both the borrower and the lender and might thus constitute an obstacle. In addition,

overall creditworthiness and knowledge about applying for a loan also appear important. See table 1 for the list of deemed obstacles to finance from a lender's perspective.

**Figure 1:** Lending Institutions in Fiji, 2010

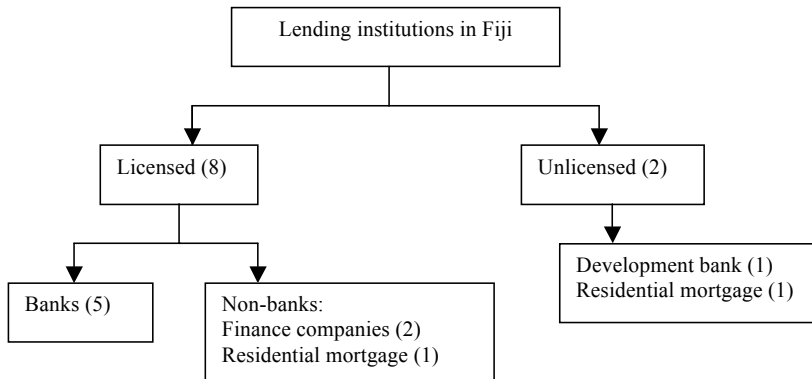


Figure 1 captures the structure of the formal financial sector lending institutions in Fiji in 2010.

Using a Likert scale to capture a respondent's perception, we asked the question: 'on a scale of 1 (major obstacle) to 7 (no obstacle), how would you generally rate the problems associated (with each of the above factors) in relation to making a loan to a (above type of) borrower?' Respondents could at all times view a scale information sheet. A pilot test returned negligible concerns with the instrument and the interview process. The survey was confined to the wider capital city area of Suva, which is the country's main business division and houses the head offices and major branches of all financial institutions operating in Fiji. Moreover, for most institutions, loan application assessments and approvals are largely centralised at the head office.

**Table 1:** Deemed Obstacles to Financing the Private Sector: a Lender's Perspective

Code	Description
KNOW	lack of <i>knowledge</i> in applying for a loan
COLL	obtaining adequate/proper <i>collateral</i>
CAP	obtaining adequate <i>capital</i> or down payment or contribution
FINR	obtaining adequate/proper <i>financial records</i>
ODOC	obtaining adequate <i>other</i> required documents
CREDIT	<i>creditworthiness</i>
COMPL	<i>compliance</i> with the terms and conditions of the loan
RPAY	<i>repayment</i> of credit and interest
RCOLL	<i>repossessing collateral</i>
LEGAL	instigating <i>legal</i> action against a defaulting borrower

Table 1 lists the variables considered in understanding the obstacles lenders in Fiji may face in financing the private sector.

At the time of the survey, there were ten lending institutions in Fiji: five banks and five non-banks (credit institutions). Of the non-banks, two are finance companies, two residential mortgage providers, and one development bank (figure 1). Of these, eight – all five banks, both finance companies, and one residential mortgage provider – are ‘licensed’ lending institutions, i.e. authorised by the regulator (RBF) to accept deposits from the public, which automatically subjects them to BIS-standard regulations on capital, asset quality, and so on. The survey was confined to licensed institutions only and all were included. The banks included: Australia and New Zealand Banking Corporation Limited (ANZ); Bank of Baroda (BOB); Bank of the South Pacific Limited (BSP); Colonial National Bank Limited (CNB); and Westpac Banking Corporation Limited (WBC). The non-banks included Credit Corporation Fiji Limited (CCFL); Merchant Finance Limited (MF); and Home Finance Company Limited (HFC), of which CCFL and MF are finance companies, and HFC is a residential mortgage provider. These institutions account for around 90% of the total loans of all lending institutions in Fiji.

We obtained responses from 63 different individuals across the eight institutions. The respondents included executive management, branch/line/department managers and other senior loans officers – all with five or more years of relevant experience; most responses (85%) were from the last two groups. Given that banks (as opposed to non-banks) provide around 92% of all credit to the private sector in Fiji and ANZ and WBC together control around 70% of the country’s total bank loans (Sharma & Brimble, 2012), the intention was to focus more on the banks and particularly on the ‘big two’.

Coincidentally, the banks and particularly the ‘big two’ were more responsive and cooperative, resulting in 70% of the total responses obtained being bank responses and 41% of the total from the ‘big two’. ANZ and WBC are also the oldest institutions in Fiji with establishments dating back to 1880 and 1901, respectively; in fact, these are the pioneer institutions across the Pacific. All banks in Fiji are foreign-owned and incorporated and one of the non-banks covered in the survey (CCFL) is also foreign-owned. Of the foreign banks, three are Australian (ANZ, CNB and WBC), one from the Sub-continent (BOB) and one from Papua New Guinea (BSP). In addition to ANZ and WBC, other institutions also have operations across the region. For example, BSP operates in Fiji, Papua New Guinea, Niue and Solomon Islands, and CCFL in Fiji, Papua New Guinea, Vanuatu and Solomon Islands.

#### **4.0 Data analysis**

The ordered probit modelling technique was employed to analyse and understand respondents’ perceptions on the extent to which the identified factors (table 1) may influence a decision to provide credit to a firm or household. To do this, we proceeded as outlined below.

##### **Quantifying Perceptions**

An essential prerequisite for using the ordered probit model is that the data to be analysed should be ordered or ranked. While our Likert scale-obtained data were already ranked, for a more meaningful analysis, we collapsed them to a three-point score. To do this, first, we ascertained a

respondent's overall perception regarding borrowers in the four different groups, where P\_PB = perception on *prospective* business borrower; P\_EB = perception on *existing* business borrower; P\_PH = perception on *prospective* household borrower; and P\_EH = perception on *existing* household borrower. To compute the overall perception, we followed the approach adopted by La Porta and co-authors (1998) in their seminal paper on law and finance, i.e. a simple average of the individual scores. Thus, for respondent X, say, if the perceptions regarding an existing business borrower (P\_EB) were as follows: KNOW = 7; COLL = 5; CAP = 2; FINR = 1; ODOC = 3; CREDIT = 4; COMPL = 3; RPAY = 7; RCOLL = 5; and LEGAL = 3; then, that respondent's overall score would be 4 or P\_EB (X) = 4. (Please see table 1 for details regarding the obstacles, e.g. KNOW = 'lack of knowledge in applying for a loan'.)

Second, the overall scores were distributed into the predetermined three clusters as follows: (i) 0 = overall scores in the range 1 to 3, indicating that identified factors are considerable obstacles to financing; (ii) 1 = an overall score of 4, indicating that factors are moderate obstacles; and (iii) 2 = scores in the range 5 to 7, indicating that identified factors are less important obstacles to financing.

### Independent Variables

It was possible that a respondent's affiliation with a particular institution could influence his or her perception such that a respondent associated with a larger institution might perceive the obstacles differently from one associated with a smaller institution. To understand the influence of such factors, we identified the independent variables listed in table 2: total assets; total liquid assets; capital base; deposits; profits before taxes; and type of institution (bank/non-bank). Intuitively, larger, more liquid, better capitalised, better funded, and more profitable institutions are likely to be less risk averse compared to smaller institutions and/or those less confident about their liquidity, capital, funding, and profitability positions. That is, it might be easier for better and stronger institutions to grant credit even in less favourable circumstances. Accordingly, with respect to institution type, banks, due to their expected better and stronger positions, are likely to be less risk averse compared to the non-banks. A back-of-the-envelope analysis shows that banks are indeed more profitable, better capitalised, and so on compared to non-banks.

**Table 2:** Independent Variables Influencing Perceptions

<b>Variable</b>	<b>Expectation</b>
Size of financial institution (measured by total assets)	Larger institutions are likely to be less risk averse (positive relationship expected: as size increases, factors become less problematic)
Liquid assets	More liquid institutions may be less risk averse (positive relationship expected: as liquidity increases, factors become less problematic)
Capital base (capital to capital of all institutions)	Larger institutions need not necessarily be better capitalised; institutions with more capital may be prepared to take more risk (positive relationship expected: as capital increases, factors become less problematic)
Deposits	Deposits being very cheap source of funds, institutions with more deposits may be less risk averse (positive relationship expected: as deposit increases, factors become less problematic)
Net profit (before tax)	More profitable institutions may be less risk averse (positive relationship expected: as profit increases, factors become less problematic)
Type of institution	Banks, due to their better and stronger positions, are expected to be less risk averse compared to non-banks (positive relationship expected)
Position of respondent	More senior staff expected to be less risk averse

Table 2 lists the variables deemed to influence perceptions of respondents, with expected relationships. For example, larger institutions are expected to be less risk averse such that as size (measured by total assets) increases, the identified factors are expected to become less problematic.

Further, the potential for cross-selling other products, once a lending relationship has been established, is likely to compensate for otherwise higher costs and risks associated with lending to certain sectors and types of borrowers (de la Torre, 2008). This practice of offering a variety of other services and products to established clients is likely to create opportunities for generating additional, and sometimes significant, revenues in the form of fees and charges. The expected ability of bigger, better funded and stronger institutions to offer a wider range of non-credit as well as other credit services and products is likely to make them less risk averse in granting a credit in the first place. A similar argument applies in the case of bank versus non-bank institutions. Accordingly, all relationships are expected to be positive such that as an institution's size, deposits and such like increase, perception scores are expected to shift towards the value of 2, reflecting the idea that the identified independent factors become increasingly less problematic in the credit granting process.



## The Model

In view of the foregoing, the following theoretical model is specified:

$$y^*_i = x^*_i \beta + \varepsilon_i$$

where  $y^*_i$  is the unobserved latent variable,  $x^*_i$  is a set of observed characteristics and  $\varepsilon_i$  the unobserved characteristics. The dependent variable  $y^*_i$  is a discrete variable that represents a choice from a set of mutually exclusive choices. Commonly known as the probit model, it has become a popular tool for explaining binary choice decisions in econometrics (Amemiya, 1981; Maddala, 1983). Since this paper considers the unobserved latent variable in more than two categories, i.e. major, moderate and less important obstacle to finance, the *ordered probit*, an extension of the probit model is utilised.

The ordered probit model is also based on one latent variable but with a different match from the latent variable,  $y^*_i$ , to the observed one ( $y_i = 1, 2, \dots, n$ ). It can be written as

$$y^*_i = x^*_i \beta + \varepsilon_i$$

$$y_i = j \quad \text{if} \quad \lambda_{j-1} < y^*_i \leq \lambda_j$$

for unknown  $\lambda_j$  with  $\lambda_0 = -\infty$ ,  $\lambda_1 = 0$  and  $\lambda_n = \infty$ . To model the outcomes,  $y_i = 1$  (identified factors are considerable obstacles to financing),  $y_i = 2$  (factors are moderate obstacles) and  $y_i = 3$  (factors are less important obstacles), it should be noted that there appears to be logical ordering in these answers. It is also rational to assume that there exist observed characteristics  $x^*_i \beta$  such that higher or lower values for these characteristics correspond with, on average, larger or smaller values for  $y_i$ . As a result, the ordered response model for this analysis can be written as:

$$y^*_i = x^*_i \beta + \varepsilon_i$$

$$y_i = 1 \quad \text{if} \quad y^*_i \leq 0$$

$$= 2 \quad \text{if} \quad 0 < y^*_i \leq \lambda$$

$$= 3 \quad \text{if} \quad y^*_i > \lambda$$

where  $y^*_i$  can be interpreted as banks' perception about borrowers, where the borrower groups include: (i) prospective business; (ii) existing business; (iii) prospective household; and (iv) existing household. The empirical model for this study can therefore be written as follows:

$$P = \beta_0 + \beta_1 TA + \beta_2 TC + \beta_3 TD + \beta_4 LA + \beta_5 NPBT + \beta_5 INST + \varepsilon_i$$

where TA = total assets; TC = total capital; TD = total deposits; LA = liquid assets; NPBT = net profit before tax; and INST = institution type. Thus, the model captures the perceptions of lending institutions in terms of a number of characteristics. For example, would there be

any difference in opinion in terms of the size of the institution measured by total assets; i.e. might larger institutions be more sympathetic compared to small ones? Similarly, would the perception of a strongly capitalised institution be any different from one with a weaker capital base? Likewise, would there be any difference in opinion across different types of institutions – banks and non-banks? The model will estimate the statistical significance and direction of the relationship between each explanatory variable and the corresponding level of perception.

## 5.0 Perceptions about prospective borrowers

### Preliminary Observations

With respect to prospective *business* borrowers, the worst perceived obstacle overall appears to be ‘instigating legal action against a defaulting borrower’ (LEGAL); the average for this factor was 3.55 (based on raw data, on a 1–7 scale, where 1 = worst obstacle and 7 = no obstacle; figure 2). The factor of least concern was ‘compliance with terms and conditions’ (COMPL); the average was 4.92. With respect to *household* borrowers, on the other hand, the worst obstacle overall appears to be ‘creditworthiness’ (CREDIT) – the average was 3.47 and the least obstacle was ‘loan repayment’ (REP), with an average of 4.04. Overall, these scores indicate that while the lenders in Fiji may be slightly less positive about *household* borrowers, they do not generally appear overly apprehensive about any of the identified factors; the scores for the worst obstacle in both cases reflect only moderate difficulty; scores of 1, 2 or even 3 do not emerge in the averages.

Figure 2: Respondents’ Perceptions about Prospective Borrowers

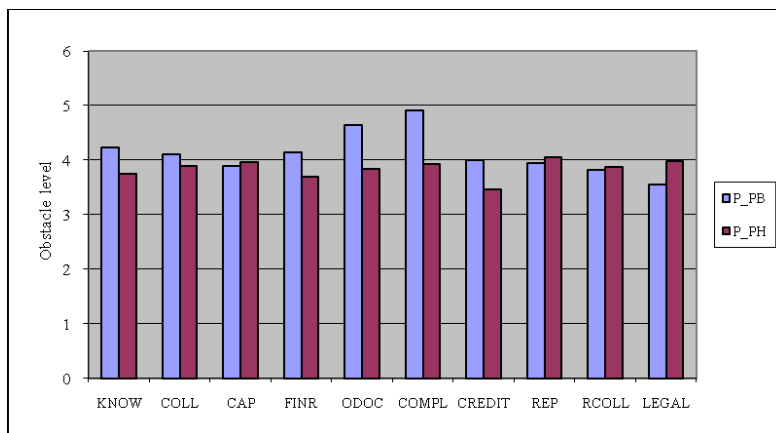


Figure 2 shows, on a scale of 1 (major obstacle) to 7 (no obstacle), the average perceptions of respondents about *prospective* business (P\_PB) and household (P\_PH) borrowers with respect to each of the variables listed in table 1. The averages exceed a value of 3, indicating that lenders may not have any major problems with any of variables with respect to both the business and household borrowers. For example, the average scores for KNOW (knowledge in applying for a loan) is 4.23 and 3.76 respectively, for P\_PB and P\_PH. The definitions of the variables are provided in table 1.

### Simple Correlations

Simple correlation tests reveal some interesting findings. First, the correlations between a respondent's perception and the independent variables (table 3) are generally weak. For example, a respondent's perception does not appear to be noticeably influenced by whether he or she is associated with a large or small institution or with one that has a large or small deposit base. However, a couple of relationships do stick out, even if not too strongly, from the rest. One is with the type of institution (Ins type) and another is with the position of the respondent (pos). With respect to the type of institution, results seem to suggest that banks may be more cautious than non-banks, and within the banking sector, larger banks may be more vigilant than smaller banks. The correlations also seem to suggest little, if any, difference in perceptions across banks and non-banks and, across institutions generally. Respondents also seem to be a bit more cautious about the household group.

**Table 3:** Simple Correlation Coefficients: Perceptions Versus Selected Independent Variables

	Prospective Business	Prospective Household	Existing Business	Existing Household
Position	-0.3076	-0.2402	-0.2291	0.0010
T. Assets	-0.0113	-0.0928	0.1838	-0.0211
T. Capital	0.0591	-0.0371	0.2380	0.0251
Net Profit (b.t.)	0.0703	-0.0561	0.2324	-0.0146
Liquid Ass.	-0.1346	-0.2763	0.0034	-0.2464
Deposits	-0.0220	-0.0989	0.1745	-0.0242
Ins type	0.2705	0.4431	0.1408	0.4237

Table 3 shows how the selected independent variables (see table 2) might influence a lender's decision to grant credit. As the coefficients indicate, the correlations are generally weak, i.e. none of the independent variables appears to have a strong influence on a lender's credit-granting decision. Thus, size, for example, may not matter. Moreover, unexpectedly, some correlations are negative, indicating inverse relationships.

With respect to the position of respondents, the correlations are negative, i.e. as the role of the lender changes from executive management to staff in the loans section, the average level of perception falls (smaller numbers reflect greater obstacle), indicating that less senior lenders may be more sceptical about the identified factors as obstacles to financing private sector credit.

Secondly, apart from the above negative correlation, other relationships are unexpectedly negative as well, including that with the size of the institution, deposit base, liquidity and number of branches. Again, while the relationships are weak, they are more pronounced with respect to perceptions on *household* borrowers. These results seem to indicate that institutions with more assets, deposits, liquid assets and outlets may be generally more cautious in financing the private sector and relatively more sceptical about the *household* sector. The institutions more readily fitting this description seem to be the larger banks, ANZ and WBC.

## Regression Results

We tested various combinations of the independent variables (table 3) on the perception of respondents. Table 4 shows the results of the ordered probit regression. The first row shows the dependent variables, i.e. perceptions of respondents about prospective business (P\_PB) and household (P\_PH) borrowers and the first column shows the independent variables, such as total assets and total capital.

**Table 4:** Perceptions about Prospective Borrowers: Ordered Probit Regressions

<b>Dependent Variable</b>	<b>Business (P_PB)</b>			<b>Household (P_PH)</b>	
	<b>Model 1</b>	<b>Model 2</b>	<b>Model 3</b>	<b>Model 1</b>	<b>Model 2</b>
Total assets	-259.73 (0.0801)*	-189.71- (0.1606)	-231.89 (0.1797)	-13.69 (0.9550)	25.42 (0.9076)
Total capital	45.68 (0.3096)	29.17 (0.0124)*	46.34 (0.3049)	26.85 (0.5693)	-1.36 (0.9235)
Total deposits	230.52 (0.0748)*	167.65 (0.2104)	201.32 (0.2057)	5.69 (0.9810)	-19.13 (0.9306)
Liquid assets	-11.85 (0.0779)*	-9.71 (0.4355)	-8.35 (0.5178)	4.18 (0.8687)	-1.36 (0.9493)
Net profit (b.t.)	-7.16 (0.7235)		-8.088 (0.6931)	-14.37 (0.5313)	
Institution type		0.25 (0.7918)	0.29 (0.7512)	2.23 (0.2534)	1.88 (0.2668)
Pseudo R squared	0.11	0.11	0.11	0.15	0.15

*p*-values are given in parentheses under the coefficients; individual coefficients are statistically significant at the \*5% level.

Table 4 presents the results of the ordered probit regressions between perceptions about prospective borrowers and selected independent variables. As the table shows, only occasionally are the correlations significant (denoted by \*). That is, the selected independent variables do not appear to exert a strong influence on granting credit to prospective private sector borrowers. Results are generally consistent with simple correlation tests (table 3).

With respect to *business* borrowers, as table 4 shows, total and liquid assets, and deposits appear to influence perception significantly in only one case (model 1; significance denoted by \*). However, the coefficient signs suggest that perception may be negatively related with the total and liquid assets but positively with deposits. That is, on one hand, larger and more liquid institutions are inclined to be more cautious in providing credit to prospective business borrowers. On the other hand, though, institutions with more deposits, as expected, are inclined to be less risk averse in providing credit<sup>4</sup>. However, when ‘institution type’ is introduced and ‘profits’ excluded from the model (model 2), a different variable – capital – appears to influence perception significantly and positively; others are not significant any more. Further, when ‘profits’ are re-introduced together with ‘institution type’ (model 3), none of the variables appears to influence perception significantly. The insignificant relationship trend continues with respect to *household* borrowers; there is no significant relationship between any of the independent variables and perception.

The picture that emerges from these results is mixed. For instance, if anything, it appears that larger, more liquid and more profitable institutions are likely to be more, rather than less, risk averse in providing credit to *prospective* borrowers generally; a result that contradicts expectations. On the other hand, institutions with more deposits and capital are likely to be less cautious. Some explanation for this is provided in section 7.

## 6.0 Perceptions about existing borrowers

### Preliminary Observations

Overall, the average scores here are higher, indicating that lenders may be more comfortable in financing customers they have already developed a relationship with (existing) compared to those they do not know well (prospective). For *business* borrowers, the aggregate average increased from 4.12 to 4.61 and for *household* borrowers from 3.84 to 4.55 (table 5). In terms of overall worst perceived obstacle, for *business* borrowers it is ‘collateral repossession’ (RCOLL; 4.24) and for *household* borrowers, COMPL and LEGAL, both at 4.39. Taken together, it appears that lenders are not very concerned about any of the identified factors being a major obstacle in financing existing and/or would-be borrowers; a score of 1, 2 or even 3 does not emerge in the averages across different categories; the lowest average is 3.47, associated with prospective household CREDIT.

**Table 5:** Overall Perceptions

	P_PB	P_PH	P_EB	P_EH
KNOW	4.23	3.76		
COLL	4.10	3.89	4.95	4.75
CAP	3.89	3.96	4.45	4.57
FINR	4.14	3.69	4.52	4.45
ODOC	4.63	3.83	5.02	4.70
COMPL	4.92	3.93	4.65	4.39
CREDIT	4.00	3.47	4.78	4.57
REP	3.95	4.04	4.56	4.52
RCOLL	3.82	3.88	4.24	4.58
LEGAL	3.55	3.98	4.33	4.39
Avg.	4.12	3.84	4.61	4.55

Table 5 compares the average perceptions of respondents across the four groups of borrowers: P\_PB = perception on *prospective business* borrower; P\_PH = perception on *prospective household* borrower; P\_EB = perception on *existing business* borrower; P\_EH = perception on *existing household* borrower. As the table shows, the averages exceed a value of 3, indicating that lenders may not have any major problems with any of variables with respect to any borrower type.

### Simple Correlations

As in the case of prospective borrowers, the correlations here too are generally weak. And again, if at all, it is the institution type that may have some influence; while less strong than in the case of prospective borrowers; at 0.14 and 0.42 for business and household borrowers, respectively, this correlation remains the highest across the identified factors (table 3). If this does indicate anything, in case of both prospective and existing borrowers, banks appear to be more watchful compared to non-banks, and within the banking sector, larger banks appear to be more careful than smaller banks.

Interestingly, the signs of some correlations shown to be negative regarding perceptions about prospective borrowers, change to positive in the case of *existing business* borrowers but they remain negative in the case of *household* borrowers. This appears to indicate that only in the case of *existing business* borrowers might the size of an institution, its deposit base, liquidity, and number of branches positively influence the perception of lenders regarding the identified factors, i.e. larger institutions, with more deposits, liquid assets and outlets may have fewer problems in financing

the *business* borrowers they have built a relationship with. While weak, these results do raise a number of questions, which we discuss in section 7.

### Regression Results

With respect to business borrowers, in contrast to the prospective group, only one variable – liquid assets – in one combination, appears to influence perceptions significantly but negatively (model 1, table 6). When ‘institution type’ is introduced in the model, the relationship remains negative but the significance disappears. While insignificant, the relationships with total assets and total capital are also negative, suggesting that if anything, larger, more liquid and better capitalised institutions are inclined to be more cautious. On the other hand, however, while also insignificant, the relationship with deposits is positive.

**Table 6** Perceptions about Existing Borrowers: Ordered Probit Regressions

<b>Dependent Variable:</b>	<b>Business (P_EB)</b>		<b>Household (P_EH)</b>	
	<b>Model 1</b>	<b>Model 2</b>	<b>Model 1</b>	<b>Model 2</b>
<b>Independent Variables</b>				
Total assets	-73.24 (0.6334)	-89.79 (0.6285)	133.87 (0.7165)	71.23 (0.0456)*
Total capital	-10.97 (0.8106)	-11.08 (0.8085)	-91.16 (0.3920)	-76.15 (0.1583)
Total deposits	84.03 (0.5345)	101.18 (0.5591)	-54.91 (0.8635)	
Liquid assets	-16.34 (0.0240)*	-18.29 (0.2012)	-27.53 (0.1261)	-28.69 (0.0814)*
Net profit (before tax)	11.51 (0.5762)	11.92 (0.5652)	28.67 (0.5009)	22.87 (0.3610)
Institution type		-0.17 (0.8742)	2.07 (0.2419)	1.82 (0.0554)*
Pseudo R squared	0.1220	0.1222	0.3001	0.2998

*p*-values are given in parentheses under the coefficients; individual coefficients are statistically significant at the \*5% level.

Table 6 presents the more meaningful results of the ordered probit regressions between perceptions about *existing* borrowers and selected independent variables. As the table shows, only occasionally are the correlations significant (denoted by \*). That is, the selected independent variables do not appear to exert a strong influence on granting further credit to existing private sector clients. Results are generally consistent with simple correlation tests (table 3).

With respect to *household* borrowers, when all variables are included in the model (model 1), none is significant; however, when deposits are excluded from the model, surprisingly, three of the variables become significant – total assets, liquid assets and institution type.

## 7.0 Implications of the results

Lenders in Fiji, particularly banks, have often used the notion ‘lack of bankable projects’ to justify the relatively lower credit levels to the private sector (e.g. ADB, 2001), meaning that proposals do not adequately satisfy a number of lending criteria, such as collateral and capital contribution. However, the analysis presented in this study shows that such claims may be tenuous. Perhaps the lenders are indifferent towards the wider community and focused on a small group of firms and/or generating significant revenues from sources other than loans (e.g. Sharma & Gounder, 2012b). If this approach allows a lender to generate relatively high profits while prudently managing credit, capital and other risks (Sharma & Brimble, 2012), then allocating resources to the wider community may not seem a good business strategy; both the profit and risk profiles could change adversely. Moreover, in a heavily bank-dominated, competition-averse credit market, smaller, profit-generating, and risk-mitigating lending portfolios make good business sense.

### The 80–20 Strategy

It is possible, as de la Torre and others (2008) note, that the lenders in Fiji are systematically seeking potential business through existing (and perhaps large and profitable) clients. The practice generally involves institutions asking existing clients for references on their best clients and suppliers. With a list of potential clients in hand, institutions contact these companies with the intention of converting them into clients as well by offering attractive (even if only initially) tailor-made, credit and non-credit services and products. Apart from additional revenues, this approach enables institutions to obtain an assessment of the quality of potential clients from established and reliable sources, who may also provide any required guarantees. This networking strategy would be useful in managing the otherwise usually suspicious but vital ‘soft’ information required in relationship lending; institutions are able not only to reduce substantially the risks involved in seeking new, unfamiliar clients but also reduce the time required for developing a relationship.

Moreover, lenders may also systematically seek out large companies with extensive networks of branches and subsidiaries of their own; the idea would be to serve the entire chain of businesses and not in one country alone, but possibly across the region. Take for example the case of the Punja’s Group, one of the many well-established, family-owned, profitable business enterprises in Fiji. It has a total of 19 related companies, 11 of which operate in Fiji and the rest across the PICs, including in Samoa, Tonga, Vanuatu, Kiribati, Solomon Islands and Papua New Guinea (<http://www.punjas.com/achievements.htm>), basically in all economies of the region. Similarly, a giant in general building, home furnishing and gardening supplies, Vinod Patel Limited, has branches in all towns and cities in the country. A number of such groups of companies operate in Fiji with branches across the country and the Pacific region.



The lack of competition in the financial sector – financial markets are either virtually non-existent or awfully shallow and inactive, and a few of banks control the dominant forms of funding and lending (e.g. Sharma & Brimble, 2011) – is likely to give rise to ‘price leadership’ or ‘signalling’ opportunities. In fact, there is a strong perception that the practice, at least in Fiji, may be real (CIFS, 1999); such practices are believed to be prevalent in other countries as well, such as Argentina, Australia and the UK (de la Torre et al., 2008). An implication of this practice is that price competition may not be an option for smaller institutions, which may otherwise be willing to provide credit at lower rates; following the ‘leader’ may be a wiser strategy.

If networking is indeed a primary business strategy for lenders in Fiji, then lending portfolios are likely to be skewed towards a relatively small group of clients, i.e. Pareto’s 80–20 rule may well be the practice (see e.g. Sanders, 1987; Mandelbrot & Hudson, 2006; and Orrell, 2010 for some discussion and application of the rule). If a lender is able to generate most of the revenues from a small group of the customers then this is the group likely to receive most attention; the rest may not count much, which may partly explain the general indifference of the lenders towards both existing and prospective borrowers, the lack of robust correlations.

### Rent Protection

Borrowers too may benefit from such a network strategy. Firms in Fiji generally, and the larger ones particularly, appear to be secretive about their business activities, as ADB notes (2001, p. 29) in explaining the reasons for the rather small number of firms listed on the stock exchange: ‘companies are mostly family businesses to whom disclosure requirements seem intrusive and rather threatening’; a very large number of these multi-million dollar, family-owned and run businesses remain unlisted (Chand, 2002; Sharma, 2009). While debt-financiers would also require confidential information for the purposes of credit granting, such information remains private, contrary to its publicity in the case of a listed firm, a comfortable outcome for the ‘secretive’ firms. Moreover, to retain this important group of clients, lenders may offer incentives such as discounted lending rates; any forgone revenues would well be compensated by the very cheap deposit funding, use of which by even the providers incurs a service charge – banks raise revenues not only via a margin on the deposit-lending activity but also on borrowed funds (deposits).

If indeed the network strategy is mutually beneficial, then it could be a case of mutual ‘rent protection’, as suggested by Rajan and Zingales (2003). The argument, in relation to financial development, is that industrial incumbents (established large industrial firms) have the ability to finance new projects out of earnings and/or borrow on collateral and reputation. Such privileged access to finance endows the incumbent with positional rents, which is likely to be impaired if financial institutions provided credit to a wider group of borrowers, thus the interest of industrial incumbents to oppose competition in the business and financial sectors. Similarly, more competition in the financial sector may compete away the powers and positional rents of incumbent financiers and thus the interest of incumbent financiers as well to oppose financial development. The mutual ‘rent protection’ objectives enable financiers to solicit the support of firms in return for privileged access to finance and protection of confidentiality. These incumbents have large economic power to determine, collectively, competition and the development of the financial sector through political influence.

## SMEs and Households

Some evidence appears to support these contentions and explanations, as evidenced by the actions of the Reserve Bank of Fiji. In addition to the capital and asset quality regulations mentioned earlier, commercial banks in Fiji have, since 2009, also been required to provide a broad range of financial services, including loans, to small and medium enterprises and households<sup>5</sup>, where a 'small enterprise' is defined as one with a turnover or total assets between \$30,000 and \$100,000 and employing between 6 and 20 employees; and a 'medium enterprise' is one with a turnover or total assets between \$100,000 and \$500,000 and employing between 21 and 50 employees. Moreover, the RBF separately and independently monitors the banks' allocation of credit to these enterprises. These RBF actions seem to suggest that banks in Fiji may indeed have had little interest in SMEs and the wider household sector.

With respect to SMEs, if indeed the 80–20 rule is being practised, these would be enterprises that fall outside the 20% group. In that case, in relation to the business borrowers, the perceptions of the respondents in our survey may well relate to these SMEs – indifferent – granting credit to firms not already in or connected to the 20% group would not be an issue. For a number of reasons, banks and other financial institutions may indeed become uninterested in financing SMEs. For example, SMEs may be relatively more opaque, i.e. it may be more difficult to ascertain if these enterprises have the capacity (viability of projects) and/or willingness (moral hazard) to repay (Berger & Udell, 1998; Cole, et al., 2004).

SMEs are also more likely to be informal, particularly in developing economies like the PICs, which not only exacerbates the 'opaqueness' problem but also poses additional obstacles and risks in lending to these enterprises (Gatti & Honorati, 2007); lack of reliable and complete financials, for example, would make it difficult for financial institutions to lend, especially if lenders are subject to regulatory guidelines such as the 'Loan Classification and Provisioning for Impaired Assets' and 'Capital Adequacy Requirements' in Fiji. Moreover, the expected high cost associated with the labour-intensive process of collecting soft information is likely to create added deterrents. A similar situation is likely to exist with respect to the wider household sector.

## 8.0 Conclusion

In light of the growing finance–private sector–economic growth findings, this article examines, from a *supply side* perspective, obstacles to private sector financing in Fiji, a small Pacific Islands, growth deprived, vulnerable economy; also a relatively understudied region with respect to the finance–growth literature.

A survey of 80 per cent of the formal financial institutions reveals that financing the private sector may not be a major problem; analysis of the data shows that lenders may be rather indifferent about the prospect. On one hand, lenders are expected to operate within the confines of the regulatory framework, i.e. safe, sound and stable operations, and on the other, accomplish business goals, including shareholder wealth maximisation. Add to this the widespread practice of, and problems associated with, ‘relationship lending’, the lack of competition in the supply of credit to the private sector, and a bank-dominated financial sector, and Pareto’s 80–20 business strategy naturally springs to mind. This strategy appears likely to be the practice in Fiji, explaining thus the ‘indifferent’ perceptions of respondents regarding to obstacles to private sector financing. This practice is likely to be prevalent across the PICs since the same major banks operate across the region.

While these results provide useful insight into the supply-side perspective, policy formulation should proceed only once the views of other stakeholders have also been obtained. For example, the views of the *demanders* of credit (firms), especially the SMEs, appear equally, if not more, important and require research. With respect to the suppliers as well, further research, for example using in-depth interviews with senior executives, and better understanding of business strategies would be useful. In the meantime, policy makers in the PICs would be encouraged to know that the supply-side component of the finance–private sector–economic growth link may not be a major concern.

## NOTES

---

<sup>1</sup> See Levine, 1997 and 2005 for comprehensive reviews; the link appears stronger in the case of developing economies.

<sup>2</sup> Banking Supervision Policy Statement No 1: Capital Adequacy Requirements for Licensed Financial Institutions:www.Reservebank.Gov.Fj.

<sup>3</sup> Banking Supervision Policy Statement No 3: Revised 2009 Guidelines for Loan Classification and Provisioning for Impaired Assets.: [Http://www.Reservebank.Gov.Fj](http://www.Reservebank.Gov.Fj).

<sup>4</sup> The ordered probit results are consistent with the simple correlation test results above, confirming the Makridakis and Hibon (2000) claim that simple analytical tools are as effective, if not more so, than the more complex methods of analysis.

<sup>5</sup> Banking Supervision Policy Statement no. 14: <http://www.reservebank.gov.fj/docs/Banking%20Supervision%20Policy%202014.pdf>.

## References

- ADB (Asian Development Bank). (2001). *Financial Sector Development in Pacific Island Member Countries: Volume 2 Country Reports*. Manila, Philippines: Author.
- Amemiya, T. (1981). Qualitative response models: a survey. *Journal of Economic Literature*, 19, 1483–1536.
- Beck, T. & Demirgüç-Kunt, A. (2006). Small and medium-size enterprises: access to finance as a growth constraint. *Journal of Banking and Finance*, 30(11), 2931–2943.
- Beck, T., Demirgüç-Kunt, A. & Levine, R. (2003). Law and finance: why does legal origin matter? *Journal of Comparative Economics*, 31, 653–675.
- Beck, T., Demirgüç-Kunt, A. & Levine, R. (2005). Law and firms' access to finance. *American Law and Economics Review*, 7, 211–252.
- Beck, T., Demirgüç-Kunt, A. & Peria, M. S. M. (2008a). *Banking services for everyone? Barriers to bank access and use around the world. (Policy Research Working Paper 4079)*. Washington, DC: World Bank.
- Beck, T., Büyükkarabacak, B., Rioja, F. & Valev, N. (2008b). *Who gets the credit? And does it matter? Household vs. firm lending across countries. (Policy Research Working Paper 4661)*. Washington, DC: World Bank.
- Berger, A & Udell, G. (1998). The economics of small business finance: the roles of private equity and debt markets in the financial growth cycle. *Journal of Banking and Finance*, 22, 613–673.
- Chand, S. (2002). Financial sector development and economic growth in Pacific Island countries. *Pacific Economic Bulletin*, 17(2), 117–133.
- CIFS (*Report of the Committee of Inquiry into Financial Services*). (1999). Ministry of Finance, Fiji, Parliamentary Paper no. 19, Parliament of Fiji, Suva.
- Clauretie, T. M. & Sirmans, G. S. (2010). *Real Estate Finance: Theory and Practice*. Cengage Learning, Mason: USA.
- Cole, R., Goldberg, L. & White, L. (2004). Cookie-cutter versus character: the micro structure of small business lending by large and small banks. *Journal of Financial and Quantitative Analysis*, 39, 227–251.
- de la Torre, A., Peria, M. S. M. & Schmukler, S. L. (2008). *Drivers and obstacles to banking SMEs: the role of competition and the institutional framework. (Policy Research Working Paper 4788)*. Washington, DC: World Bank.
- Demirgüç-Kunt, A. & Maksimovic, V. (1998). Law, finance, and firm growth. *Journal of Finance*, 53, 2107–2137.
- Demirgüç-Kunt, A. & Levine, R. (2008). *Finance and economic opportunity. (Policy Research Working Paper 4468)*. Washington, DC: World Bank.
- Gatti, R. & Honorati, M. (2007). *Informality among formal firms: firm-level, cross-country evidence on tax compliance and access to credit. (Policy Research Working Paper 4476)*. Washington, DC: World Bank.
- Garretsen, H., Lensink, R. & Sterken, E. (2004). Growth, financial development, societal norms and legal institutions. *Journal of International Financial Markets Institutions and Money*, 14(2), 165–83.
- Gup, B. E. & Kolari, J. W. (2005). *Commercial Banking: The Management of Risk*. John Wiley and Sons, NJ: USA.
- Koch, T. W. & MacDonald, S. S. (2010). *Bank Management*. Cengage Learning, Mason: USA.
- La Porta, R., Lopez-de-Silanes, F., Shleifer, A. & Vishny, R. (1997). Legal determinants of external finance. *Journal of Finance*, 52, 1131–1150.

- La Porta, R., Lopez-de-Silanes, F., Shleifer A. & Vishny, R. (1998). Law and finance. *Journal of Political Economy*, 106, 1113–1155.
- Levine, R. (1997). Financial development and economic growth: views and agenda. *Journal of Economic Literature*, 35, 688–726.
- Levine, R. (2005). Finance and growth: Theory and evidence. In P. Aghion & S. Durlauf (Eds.), *Handbook of economic growth* (pp. 865–934). Oxford, UK: Elsevier.
- Maddala, G. (1983). *Limited dependent and qualitative variables in econometrics*. Cambridge, UK: Cambridge University Press.
- Makridakis, S. & Hibon, M. (2000). The M3–competition: results, conclusions and implications. *International Journal of Forecasting*, 16, 451–476.
- Mandelbrot, B. & Hudson, R. L. (2006). *The (mis)behaviour of markets: a fractal view of financial turbulence*. Basic Books, NY: USA.
- Orrell, D. (2010), *Economyths: ten ways that economics gets it wrong*. London, UK: Icons Books.
- Rajan, R. G. & Zingales, L. (2003). The great reversals: the politics of financial development in the twentieth century. *Journal of Financial Economics*, 69(1), 5–50.
- Sanders, R. E. (1987). The Pareto principle: its use and abuse. *The Journal of Services Marketing*, 1(2) 37–40.
- Sharma, P. (2009), *Financial Development in Fiji* (Unpublished doctoral dissertation). Griffith University, Australia.
- Sharma, P. & Roca, E. (2012). It is time to re-examine the role of stock markets in developing economies. *Journal of Asia–Pacific Business*, 13, 1–23.
- Sharma, P & Brimble, M. (2011). Sustainable development in the small states of the South Pacific: toward a corporate social responsibility for international banks, *Fijian Studies*, 9(2), 23–51.
- Sharma, P. & Gounder, N. (2012a). Obstacles to bank financing of micro and small enterprises: empirical evidence from the Pacific with some policy implications, *Asia Pacific Development Journal*, 19(2), 49–75.
- Sharma, P. & Gounder, N. (2012). Profitability determinants of deposit institutions in small financial systems: the case of Fiji, Discussion Papers in Finance, 2012–06, Griffith University.
- Sharma, P. & Nguyen, T. (2010). Law and banking development in a South Pacific island economy: the case of Fiji, 1970–2006. *Journal of Asia Pacific Economy*, 15(2), 192–216.

