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Full Length Research Paper

Debt financing to new small ventures in South Africa: The impact of collateral, ethics and the legal system

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The purpose of the study on which this article is based was to ascertain to what extent collateral, ethics and the legal system impact on the availability of bank and trade credit to new SMEs in South Africa. Focusing on both commercial banks (using collateral) and trade creditors (unsecured), this study created a unique opportunity to assess the impact of collateral on the importance of ethical behavior and the efficiency of the legal system as prerequisites for the availability of external debt to new SMEs. The legal systems of countries are also not equally efficient, and could even differ in terms of secured and unsecured debt, which, in turn, could influence the ethical behavior of the entrepreneur. The complex relationship between collateral, ethics and the legal system and how it influences the availability of external debt are accentuated. The article also gives insight to entrepreneurs and government regarding potential reasons for the non-availability of credit from trade creditors and commercial banks to new SMEs.

Key words: Debt finance, SMEs, collateral, legal system, ethics.

INTRODUCTION

Various challenges and impediments not only limit the creation of new small and medium enterprises (SMEs), but also contribute to their high failure rates. One of these challenges is the non-availability of formal sector financing. The financing problem of new SMEs is particularly pressing in developing countries. South Africa, for example, does not only have a very low new venture birth rate, but it also suffers from one of the highest failure rates of SMEs in the world. In addition, the lack of financial support is the second most reported contributor to the low new firm creation and failure rate in South Africa (Herrington et al., 2009). New SMEs need external financing to survive and grow, and commercial banks and even trade creditors are often criticized by policy-makers and SMEs for neglecting them and not providing financing to new ventures (Beck et al., 2008).

Various studies have focused on the financing problem of new SMEs. Mutezo (2005) reports this to be one of the most difficult problems to solve. Carpenter and Peterson (2002) see a direct link between SME growth and the availability of external financing. The Kauffman Foundation (2007) recognizes that external debt financing, such as bank loans and trade credit, are the most important sources of funding for new SMEs. Studies by Reitan and Waago (2002), Statistics Canada (2007) and Berger and Udell (2002) confirm both the availability and the importance of external debt finance to SMEs in developed countries. In contrast, Beck (2007) found that new SMEs in developing countries report a widespread shortage of external debt finance.

The question arises whether commercial banks (and sometimes trade creditors) deserve the blame for the financing problems of new SMEs. Berry et al. (2002) state that new SMEs are not always able to present full accounting records and other documentation (hard

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information) required by creditors, thereby making the appraisal of their credit applications very difficult. Berger and Udell (2006) contend that new SMEs are the most information opaque due to their lack of a track record. Moral hazard and information asymmetry lead to credit rationing and a shortfall in debt provision (Holmes and Cassar, 2003). In the absence of hard information about the SME, collateral could help reduce information asymmetries and moral hazard problems that could arise between creditors and entrepreneurs (Coco, 2000). Commercial banks, typically, require collateral as security from new SMEs to compensate for the lack of hard information, while trade credit is usually granted without expecting collateral.

The perception of ethical behavior (Hannafey 2003) and the efficiency of the legal system (Meiners et al., 2005) are two additional factors influencing the credit granting decision. Hannafey (2003) argues that ethics may well be the most important assessment that a lender can make about the prospective borrower. The legal system could also impact both ethical behavior and the quality of collateral. Ethics is influenced by the efficiency of the legal system to punish unethical behavior, while the value of collateral depends on the ability to legally collect the outstanding debt. Cilliers and Benade (2001) differentiate between creditors with and without collateral and accentuate that the legal process (collecting outstanding debt) to be followed by the unsecured creditor is substantially more lengthy and complex in South Africa. Creditors with collateral (typically banks), relative to unsecured creditors (typically trade creditors), have therefore better legal protection and can usually collect their outstanding debt without necessarily following lengthy and costly legal battles.

The focus of the research is to determine how ethics, the legal system and collateral influence the non-availability of debt/credit to new SMEs. Commercial banks usually require collateral, while trade creditors typically are unsecured. Although the empirical research was conducted in South Africa, the focus was unique and the results have universal value. Focusing on the suppliers of credit in a developing country helps to determine to what extent credit is available to new SMEs. Combining secured and unsecured creditors in the same study create a unique opportunity to assess whether collateral influence the importance of both ethical behavior and the efficiency of the legal system in the credit granting decision. The delicate balance between collateral, ethical behavior and the efficiency of the legal system and how it influences the availability of credit to new SMEs are universal concerns.

LITERATURE REVIEW

Capital structure is described as the mix of debt and equity that a firm uses to finance its operations (Gitman, 2003). The theoretical principles underlying capital structure can generally be described in terms of the static trade-off theory by Modigliani and Miller (1958, 1963) the agency theory by Jensen and Meckling (1976) and extended by Stiglitz and Weiss (1981) and the pecking order theory by Myers (1984). Modigliani and Miller (1963) argue that because the interest on debt is tax-deductible, thereby creating tax savings for the borrower, it becomes possible for firms to minimize their costs of capital and maximize shareholders' wealth by using debt. The agency theory of Jensen and Meckling (1976) was based on the conflicts between the shareholders and managers of the firm and the equity holders and debt holders. Conflicts between shareholders and managers arise because managers do not hold total residual claim thus they cannot capture the entire gain from their value-maximizing activities. On the other hand, conflict arises between debt holders and equity holders because debt contracts give equity holders an incentive to invest sub-optimally. The debt contract results in asymmetric distribution of the gains. According to Stiglitz and Weiss (1981) agency problems such as asymmetric information and moral hazards can impact on the accessibility of credit and hence the capital structure of SMEs. Myers (1984) alludes in the pecking order theory that there is no well-defined optimal capital structure; instead the debt ratio is the result of hierarchical financing over time. Management has a preference to choose internal financing before external financing. When a firm is forced to use external financing sources, managers select the least risky and demanding source first. When it is necessary to issue external sources, debt issuance is preferred to new equity. The pecking order theory suggests the use of external debt before the use of external equity by SMEs. Frelinghaus et al. (2005) point out that despite the disadvantages of debt (financial distress), the inadequacy of internal equity and the non-availability of external equity imply that debt is one of the principal sources of finance for SMEs.

The financing problem of new SMEs is that of finding funds at the right time, the right type, and in the right quantities at various stages of development. Timmons and Spinelli (2009) identified the importance of both internal and external sources of financing for successful new venture creation. Internal sources refer to equity contributions and savings from the founders and from family and friends, while external sources could be divided between venture capital (external equity) and debt. The vast majority of new SMEs depend on internal finance (contribution from the owners, family and friends). However, internal finance is often inadequate for new SMEs to survive and grow, especially in a developing country. A large percentage of new SME failure is attributed to inadequate capital structure or resource poverty. Carpenter and Petersen (2002) found that the growth

of new SMEs is constrained by their dependence on internal finance and their limited access to external financing.

Venture capital (external equity) could potentially be a major source of SME funding, but Demirguc-Kunt et al. (2006) argued that external equity in the form of venture capital or the stock exchange is usually not available to new SMEs. Various studies have confirmed that less than five percent of new SMEs have access to venture capital (Berger and Udell, 2002; Timmons and Spinelli, 2009). The lack of internal sources and venture capital funds makes many new SMEs dependent on bank loans, overdrafts and suppliers credit for early-stage financing (Blumberg and Letterie, 2008). The Kauffman Foundation (2007) disclosed that external debt is the most important type of financing for new firms, more important than insider debt (from friends, family and spouses), internal equity (own contribution) or venture capital. New SMEs in developed countries do not report an inability to access external debt finance and most of them are able to obtain sufficient credit from banks and other credit institutions (OECD 2006). Reitan and Waago (2002) found that commercial banks are the most dominant source of finance for new SMEs in most European countries, financing about 61% of the capital needs of new SMEs. Statistics Canada (2007) points out that there is approximately 82% approval rate by banks for credit applications from new SMEs in Canada. In addition, 45% of new SMEs are able to access trade credit. In England 71% of applications for credit by new SMEs from financial institutions was approved and only 26% were wholly or partially rejected. In the USA, more than 50 percent of new SMEs are able to access credit from commercial banks and trade creditors (Berger, and Udell, 2002).

Despite the dependence of SMEs on debt finance, access to debt finance is very limited for new SMEs especially in developing countries. Commercial banks and trade creditors hesitate to lend to new SMEs. Often new SMEs could use funds productively if only they were available, but cannot obtain debt finance from the formal financial system. Timmons and Spinelli (2009) confirm that banks regard new ventures as high risk, therefore require collateral or a substantial own contribution from the owners. Beck (2007) found that new SMEs in developing countries reported a widespread shortage of external debt finance. According to FinMark Trust (2006) only two percent of new SMEs in South Africa are able to access bank loans, while Foxcroft et al. (2002) reported that 75% of SME applications for bank credit in South Africa were rejected. In addition, Berger and Udell (2006) comment on the importance of trade credit to new SMEs, focusing on the issue that, unlike commercial banks, trade credit usually does not require collateral.

In summary, the availability of internal equity and debt (own contribution as well as from friends and family), especially in developing countries, is very limited.

Venture capital is seldom an option for new SMEs anywhere in the world. This accentuates the importance of debt as a primary source of financing for new SMEs. Bank loans and trade credit could constitute more than 50% of the typical start-up capital of a new venture in developed countries. However, the question remains to what extent debt is accessible in developing countries, which could lead to a debt gap. According to Poutziouris et al. (2002) the debt gap represents the problematic flow of debt from financial agents to SMEs. The Organization of Economic Cooperation and Development (OECD) confirmed that the debt gap is more pervasive for new SMEs in developing countries than those in developed countries (OECD 2006). The non-availability of trade credit, which could act as a substitute for bank debt, further compounds the debt gap. Conventional wisdom amongst policy makers holds that banks, especially the big banks, simply neglect the SME sector (Beck et al., 2008). Angela Motsa and Associates (2004) contend that banks do not have many products specifically aimed at SMEs and Hawkins (2002) observes that existing evidence points to a banking sector that has been slow to change its focus on SMEs. Regardless of these criticisms, the availability of debt depends on credit risk.

CREDIT ASSESSMENT

Risk perception is the subjective judgment that people make about the characteristics and the severity of a risk. The risk perception about new SMEs, which is high because of their high failure rate, is one of the reasons for the low access to debt finance (Tagoe et al., 2005). The criteria for lending by trade creditors and banks usually include hard information such as financial statements, reports from credit rating agencies, and acceptable bank and trade references (Burhart and Ellingsen, 2004).

In a perfect market setting with full information available to both parties in the contract, a finance gap would not occur. However, financial markets are characterized by a number of market imperfections, including information asymmetry. To analyze financial ratios and do credit scoring to assess risk, hard information is needed. It implies that audited financial statements are available, and the profitability and solvency ratios of the firm are good (Wiedenhofer, 2006). For existing SMEs in information rich environments, small business credit scoring and financial statement lending may be feasible, but it makes it extremely difficult for new SMEs in developing countries to obtain debt. Additionally, the SME finance market is characterized by risk and uncertainty regarding the future conditions of the firm. From the creditors' perspective, there is incomplete information about the underlying quality of the project and the management of the small firm, giving rise to the problem of adverse

selection. Furthermore, the management of the SME may fail to perform to their full capabilities, giving rise to the problem of moral hazard. Moral hazard and information asymmetry lead to credit rationing and a shortfall in debt provision (Holmes and Cassar, 2003).

Beck (2007) argues that the availability of finance to new SMEs can also be influenced by both borrower-specific (internal factors) and systemic factors (external factors). Cassar (2004) and Barbosa and Moraes (2004) point out that borrower-specific factors include managerial competencies, quality of business information, availability of collateral, ethical behavior, networking and other variables largely controllable by a firm. A firm's internal environment represents factors that are largely controllable by the firm. These factors may influence the availability of finance to new SMEs. Furthermore, the scope for optimization that the lender will manage lending costs and risks can also be constrained by external or systemic factors (also known as state variables), such as the contractual (legal) and informational frameworks, macro-economic environment, social factors (crime and corruption) and other characteristics of the business environment in which both the lender and borrower operate. These state variables are not only outside the reach of lenders' actions, but neither can policy makers change them in the short-run. Beck (2007) adds that the weaker these state variables are, the less the maneuvering room for credit supply optimization. Given these constraints, there is the possibility that lenders will not maximize their lending opportunities to SMEs.

In recent years, bankruptcies and global competition have increased the need for accurate credit analysis. Banks also want to reduce the cost of lending. In summary, the most general factors impacting on credit evaluation and scoring are the five Cs of credit: *character* (willingness of customer), *capacity* (customer's ability), *capital* (customer's financial reserves or net asset value), *collateral* (pledged assets) and (general economic) *conditions* (Firer et al., 2008). It is interesting to note that two factors (capacity and capital) are based on hard information, economic conditions refer to the external environment, character (ethical behavior) refers to soft information, while collateral is needed when insufficient hard and soft information to grant credit is available. The primary focus of this article is on collateral, ethical behavior and the legal system.

Collateral

Timmons and Spinelli (2009) agreed that the relationship between creditors and new SME owners is usually established under conditions of uncertainty and information asymmetry. In the absence of a credit history or assets to serve as collateral, it is difficult to secure loans from financial institutions, which is typically the problem encountered by young and previously disadvantaged people (Herrington et al., 2009). Collateral refers to assets pledged by a borrower to a lender as security for payment of debt. Collateral helps reduce information asymmetries and moral hazard problems that could arise between banks and entrepreneurs (Coco, 2000). Berger and Udell (2006) find that new SMEs are the most information opaque because they have no track record. Therefore taking collateral as security is attractive to bankers because the willingness to offer collateral signals the confidence of the entrepreneur in his/her abilities and in the likely success of the business. Collateral thus positively impacts on the risk perception of the entrepreneur and the business.

Cassar (2004) argues that asset structure should also be related to capital structure, particularly for new SMEs. The more tangible and generic the firm's assets are, the greater the firm's liquidation value, thereby reducing the financial loss incurred by financiers should the company default and the firm's assets be realized. Firms can also reduce adverse selection and moral hazard costs by pledging their assets as collateral. This will result in firms with assets of greater liquidation value getting easier access to finance, and lower costs of financing, leading in turn to these firms acquiring a higher level of debt in their capital structure. In addition, potential investors may be more likely to invest in a project if the entrepreneur is investing his/her own capital. Internal capital includes founders' capital and contribution from family and friends. This will improve the credibility of the project (Bollingtoft et al., 2003).

Unfortunately, Hawkins (2002) and the World Bank (2004) reiterate that owners of new SMEs often lack collateral, specifically in developing countries. The Umsobomvu Youth Fund (2008) reports that most new SMEs in South Africa start business without any acceptable collateral. In addition, their personal contribution (owners' equity contribution) is often very low and inadequate. Consequently, it is hypothesized that there is a significant positive relationship between lack of collateral and non-availability of debt to new SMEs.

H_{1a}: Insufficient collateral is a significant reason for the non-availability of bank loans to new SMEs.

H_{1b}: Insufficient collateral is a significant reason for the non-availability of trade credit to new SMEs.

Ethics

Hellriegel et al. (2008) note that ethics entails the code of moral principles and values that directs the behavior of an individual or a group in terms of what is right or wrong. Business ethics also involves a company's compliance with legal standards and adherence to internal rules and regulations. Generally, business ethics can be defined as

the methods, principles and processes a business or organization brings to bear on compliance to legislation; compliance to regulatory and professional standards; compliance to company standards; keeping promises and commitments; and abiding by general principles or values such as fairness, truth, honesty and respect. "Compliance to legislation" therefore links ethics to the legal system and the extent to which individuals respect the legal system in a country.

Howorth and Moro (2006) agree that ethics and trust play an important role in reducing agency problems such as moral hazard and adverse selection. The decision to lend by providers of funds is often based on the assessment of financial statements and/or the provision of collateral, and/or credit scoring. These three lending technologies are all based on hard facts and public information available. Private information is often soft data, which, by definition, is difficult to summarize in numeric score, and is influenced by the context in which it is collected. This indicates the central role of soft information in the lending process, since the essence of successful lending is overcoming asymmetric information problems between the borrower and the lender. This implies that there are different sources of information that lead to the decision to lend. Where ethics is low, the general perception of riskiness is greater. In addition, contracts will be more stringent with tight terms and conditions. This includes tight monitoring and collateral.

The ethical perception of new SMEs by commercial banks and trade creditors may affect their willingness to grant credit to new SMEs. Young firms face significant resource pressure. Thus the liability of newness may lead new firms towards more individualist ethical postures such as non-repayment of credit. Hannafey (2003) argues that, although certainly the least quantifiable, ethics (which includes the character and personality) may well be the most important assessment that a lender can make about the prospective borrower. Regardless of the positive attributes of capacity, collateral and credit history that the borrower may have, if he/she does not demonstrate integrity and trustworthiness, any credit proposal may be declined. Ethics is important because, amongst other things, reveals intent.

H_{2a}: Unethical behavior is a significant reason for the non-availability of bank loans to new SMEs.
H_{2b}: Unethical behavior is a significant reason for the non-availability of trade credit to new SMEs.

Legal system

The OECD (2006) shows that market imperfections such as those caused by inefficient legal systems can constrain the ability of firms to access external finance. Firms in countries with more efficient legal systems should therefore obtain more external financing than firms in countries with less efficient legal systems. Meiners et al. (2005) point out that there is no general definition of law. Law is an abstract term that can be defined in many ways. Law is a statement of the circumstances in which the public force is brought to bear through the courts and laws may also be viewed as a collection of rules and principles intended to limit and direct human behavior. Therefore, law and the legal system play several key roles in society, such as influencing the behavior of members of the society, resolving disputes, social maintenance and social change (Meiners et al., 2005).

The link between ethics and the legal system is clear. The law of a country and the efficiency of its legal system should have substantial influence on the ethical behavior of its citizens. Furthermore, La Porta et al. (1997) and Levine (1999) set up the theoretical basis for the development of empirical studies in respect of the relationship between law and finance. They argue that focusing on the capital structure (Modigliani and Miller finance theory) or collateral of a firm is not sufficient to make the credit-granting decision. The defining feature of any debt is the legal rights that they bring to their owners. For example, debt entitles creditors to repossess collateral when the company fails to make promised payments and creditors are thus paid because they have this power. Without these rights creditors would not get paid and firms would find it difficult to raise external finance. Law and the quality of its enforcement are potentially important determinants of what rights creditors have and how well these rights are protected.

The differences in legal protection of creditors might help explain why firms are financed differently in different countries. Djankov et al. (2005) developed a credit right index to compare creditor protection in 129 countries. The index ranges from zero (weak creditor rights) to four (strong creditor rights). Protection of creditors in South Africa, with a score of three, seems to be very high. It should be noted that the index focuses predominantly on secured creditors. Creditor protection, bankruptcy and insolvency of firms and protection of creditors in South Africa are governed by the Insolvency Act 24 of 1936 as amended and the Bankruptcy Act (Visser et al., 2005). Secured creditors, according to the Insolvency Act (Cilliers, and Benade, 2001), can simply claim the proceeds from the secured asset, which is not an option available to the unsecured creditor. If the debtor fails to pay, the secured creditor could sell the collateralized asset to settle the debt. The legal process to be followed by the unsecured creditor is substantially more lengthy and complex (Cilliers and Benade, 2001). The advantage of collateral to the secured creditor is that upon default he may obtain an attached order and satisfy his debt from the sale of the object. In the event of sequestration of the debtor, the proceeds from the property (collateral) thus

Table 1. Perception of rejection rates by commercial banks and trade creditors.

Variable	Commercial banks (%)	Trade creditors (%)
Extremely high	78	72
Very high	15	13
Moderately high	6	14
Do not know	0	0
Moderately low	1	1
Very low	0	0
Extremely low	0	0
Total	100	100

separated are, amongst others, applied to satisfy the debt of the secured creditor who therefore has priority over the ordinary (unsecured) creditor to the amount of the secured debt (Nagel 2006).

It can be concluded that, relative to unsecured creditors, creditors with collateral have better legal protection in South Africa and can usually collect their outstanding debt without necessarily following lengthy and costly legal battles. In addition, the World Bank (2003) revealed a relatively inefficient legal system in South Africa compared to developed countries, reporting a shortage of judges and magistrates, backlog of cases and lower creditor protection in practice. This suggests that, although the law of the country according to the creditor right index is good, the inefficient application of the legal system in South Africa could lead to non-availability of debt to new SMEs. In addition, secured creditors are better protected by the law and less exposed to the inefficiency of the legal system. Thus it is hypothesized that there is a significant relationship between the perceptions of creditors regarding the efficiency of the legal system and non-availability of debt to new SMEs:

H_{3a}: The inefficiency of the legal system is a significant reason for the non-availability of bank loans to new SMEs.
H_{3b}: The inefficiency of the legal system is a significant reason for the non-availability of trade credit to new SMEs.

METHODOLOGY

The study used the quantitative research design and survey research method. Data for the research was gathered through self-administered questionnaires in 2009. Seven-point Likert scale questions were used except for demographic questions. The question items were developed after a thorough review of the literature on collateral, ethics and the legal system. The empirical study concentrated on the branches of the four major banks and Small Business Units in the Eastern Cape Province of South Africa. The four major banks included in the study were ABSA, First National Bank, Standard Bank and Nedcor. The four banks are responsible for 82% of all assets and 80% of all liabilities in commercial banking in South Africa (Okeahalam, 2001). The population of the branches of the four big banks in the Eastern Cape was obtained from the Branch Locators on the websites of the four banks. The population of commercial banks was 294. The bank officials completed the questionnaires in their personal capacities and their opinions did not represent the opinion of their banks. The researcher also focused on trade creditors in the wholesale, retail and manufacturing sectors. According to Selima (2007), these three sectors account for most of the trade credits. The population frame of trade creditors was obtained from the Border-Kei Chamber of Commerce, the Port Elizabeth Regional Chamber of commerce and the Enterprise Black Business Directory. The population of big firms and SMEs that are in the wholesale, retail and manufacturing was 541. The Raosoft sample size calculator was used, taking the margin of error, the confidence level, the population and the response distribution into consideration in determining sample size (Raosoft, 2008). Using the Raosoft sample size calculator at five percent margin of error and 95% confidence interval the sample size for banks was 167. The sample size for trade creditors was 225. For the main survey 376 questionnaires were administered to commercial banks and 172 questionnaires were returned. The response rate for commercial banks was 45.8%. For trade creditors, 315 questionnaires were administered and 233 returned. The response rate for trade creditors was 74.0%. Overall 691 questionnaires were administered to both commercial banks and trade creditors and 405 were returned. The average response rate was 58.6%.

RESULTS

Table 1 examines the perception of the respondents (commercial banks and trade creditors) of the credit rejection rates of the applications (new SMEs). Table 1 shows that the rejection rates of credit applications from new SMEs by commercial banks and trade creditors are extremely high. According to Blumberg and Letterie (2008), the rejection rate of SMEs can be used as a proxy for the availability of debt finance to new SMEs. The extremely high rejection rates indicate low availability of debt finance from commercial banks and trade creditors to new SMEs, which confirms the results from other developing countries.

An item analysis was performed to investigate the means, standard deviation, skewness and kurtosis of the identified factors for both commercial banks and trade

Table 2. Mean scores and Cronbach's alphas for trade creditors and banks.

Factor and item	Commercial banks	Trade creditors
	Mean	Mean
Ethical perception		
Perception of payment default	3.26	5.72
Perception of dishonesty in keeping commitments	3.08	5.66
Perception of intend to divert funds to non-core activities	3.54	5.34
Perception of false/padded information	1.92	5.44
Mean	2.92	5.54
Cronbach's alpha	0.789	0.752
Inefficient legal system		
Costly to get a judgment	4.02	6.34
Takes time to get a judgment	3.48	6.30
Courts are not fair or impartial	2.35	4.60
Court decisions are not enforced	2.16	4.18
Weak confidence in legal system	2.02	4.62
Mean	2.81	5.20
Cronbach's alpha	0.777	0.710
Collateral		
No tangible assets (such as building as collateral)	6.95	1.22
Low level of equity contribution of owner	6.92	6.02
Lack of guarantee by the owner of the firm	5.15	2.05
No current assets as collateral	5.02	2.01
Mean	6.01	2.83
Cronbach's alpha	0.825	0.725

creditors. The Cronbach's alpha was used as the measure of reliability. In addition, the T-test was used to determine if there were significant differences in the mean scores of commercial banks and trade creditors. The results of the correlation are presented. Since the results of item analysis, T-test and the correlation are related, their results are discussed together.

Table 2 presents the mean scores of the reasons why credit is not available from commercial banks and trade creditors to new SMEs. A seven-point Likert scale was used and the respondents had to indicate their level of agreement with each statement as a possible reason why they do not grant credit to new SMEs (1 – strongly disagree to 7 – strongly agree). The Cronbach's alphas are also presented.

The T-test was used to determine if there were differences in the mean scores of commercial banks and trade creditors with respect to the internal and external factors. Table 3 presents the results of the T-test.

Pearson correlation was used to test for the direction and strength of relationship between the business environ-mental factors and non-availability of debt. Table 4 presents the results of the correlation.

The scale means of ethical perception are 2.92 for commercial banks and 5.54 for trade creditors. The seven-point Likert scale was used and four is the midpoint. The Cronbach's alpha for the factor yielded a value of 0.789 for commercial banks and 0.752 for trade creditors indicating the reliability of the factor. The T-test (sig. 0.04) shows that there is a significant difference in the two sets of means. The Pearson correlation results are: Commercial banks ($r = 0.168$, p-value = 0.12), trade creditors ($r = 0.732$, p-value = 0.03). The results indicate that there is no significant relationship between unethical perception of new SMEs and the non-availability of debt from commercial banks (reject H_{2a}). However, the results show that there is a significant positive relationship between the unethical perception of new SMEs and non-availability of debt from trade creditors (accept H_{2b}).

The scale means of the inefficient legal system are 2.81 and 5.20 for commercial banks and trade creditors, respectively. The Cronbach's alpha for the factor yielded a value of 0.777 for commercial banks and 0.710 for trade creditors indicating the reliability of the factor. The T-test shows that there is a significant difference in the two sets of means. The Pearson correlation results are: Commercial banks ($r = 0.146$, p-value = 0.25), trade creditors ($r = 0.657$, p-value = 0.01). The results indicate

Table 3. T-test for differences in the mean scores of commercial banks and trade creditors.

Factor	Scale means for commercial banks	Scale means for trade creditors	T-test significance
Ethical perception	2.92	5.54	0.04
Inefficient legal system	2.81	5.20	0.03
Lack of collateral	6.01	2.83	0.01

Sig. at 0.05 (2-tailed).

Table 4. Correlation results for commercial banks and trade creditors.

Factor	Commercial banks		Trade creditors	
	R	P-value	R	P-value
Ethical perception	0.168	0.18	0.732	0.03
Inefficient legal system	0.146	0.25	0.657	0.01
Lack of collateral	0.956	0.01	0.191	0.26

Sig. 0.05 (2-tailed).

that there is no significant relationship between the inefficiency of the legal system and the non-availability of debt from commercial banks (reject H_{3a}). However, the results indicate a significant positive relationship between the inefficiency of the legal system and non-availability of debt from trade creditors (accept H_{3b}).

The scale means of lack of collateral for commercial banks and trade creditors are 6.01 and 2.83, respectively. The Cronbach's alpha for the factor yielded a value of 0.825 for commercial banks and 0.725 for trade creditors indicating the reliability of the factor. The significance of the relationships was tested through the Pearson correlation ($r = 0.956$, p-value = 0.01) for commercial banks and ($r = 0.191$, p-value = 0.26) for trade creditors. The results indicate that there is a significant positive relationship between lack of collateral and non-availability of debt from commercial banks (accept H_{1a}) and a weak insignificant relationship for trade creditors (reject H_{1b}). In addition, the T-test shows a significant difference in the mean scores of the two sets of respondents regarding ethics, the legal system and collateral.

DISCUSSION

The purpose of this study was to determine to what extent ethics (of the entrepreneur) the legal system and collateral influence the non-availability of credit to new SMEs from commercial banks and trade creditors. The study created a unique opportunity to focus on reasons for the non-availability from the supply side of credit, also combining the two most important sources of external debt to SMEs, namely commercial banks and trade creditors. Table 1 showed that neither commercial banks nor trade creditors grant credit to new SMEs (both banks and suppliers indicated 99% rejection rates ranging from extremely to moderately high). The finding on the non-availability of credit to new SMEs correlates with previous findings in South Africa (FinMark Trust, 2006). The next step was to find possible reasons for the non-availability of credit to new SMEs. The respondents from the banks and trade creditors had to indicate on a seven-point Likert scale to what extent they agree with specific statements on ethics, the legal system and collateral as possible reasons to explain why credit applications from new SMEs are rejected.

Theory suggested that the perception of ethical behavior is positively associated with the availability of debt, especially in the typical new SME environment of information asymmetry or limited hard information. This research confirms that trade creditors regard the unethical behavior of new SME owners as a significant reason for the non-availability of trade credit. All the statements regarding ethics (Table 2) had mean values of more than 5.30 with an average of 5.54, leading to the acceptance of H_{2b}. It was, however, surprising that H2a was rejected, indicating that commercial banks do not regard unethical behavior as a significant reason for the non-availability of credit to new SMEs. The mean score of 2.93 for ethical perception was well below the mean average of 4.00. The T-test value of 0.03 (Table 3) indicated a significant difference between banks and trade creditors regarding the importance of ethics.

Regarding the inefficiency of the legal system, there was again a considerable difference between trade creditors (5.21) and commercial banks (2.81). According to the trade creditors the inefficiency of the legal system in South Africa is a significant reason for the non-

availability of trade credit to new SMEs, thus H_{3b} is accepted. All the individual statements had scores above the middle value of 4.00, with “costly” (6.34) and “takes time to get a judgment” (6.30) rated as major problems in the South African legal environment. In contrast, respondents from commercial banks rejected H3a, indicating that the inefficiency of the legal system is not a significant reason for the non-availability of debt. The T-test (0.03) confirmed the significant differences between trade creditors and banks.

The results were surprising, given that both banks and trade creditors were referring to new SMEs which were operating in the same legal environment. In both cases unethical behavior and the inefficiency of the legal system were significant reasons for trade creditors to explain the non-availability of credit to new SMEs, while banks did not regard them as significant reasons. It seems, however, as if collateral supplies the answer to this apparent contradiction. Trade creditors (2.83) did not regard collateral from new SMEs as a reason for the non-availability of credit, thus rejecting H_{1b}, while banks (6.01) regarded it as the most significant reason (accepting H_{1a}). The T-test (0.01) accentuates the significant difference, which confirms that banks often rely on collateral to reduce moral hazard and information asymmetry (Blumberg and Letterie, 2008), while trade creditors typically do not require collateral.

Having sufficient collateral, as in the case of banks, could compensate sufficiently for the perception of unethical behavior. In this regard, Cilliers and Benade (2001) have suggested that the legal system in South Africa is much more efficient for the secured creditor (banks), leaving the unsecured lender (trade creditors) over-exposed. Ethical behavior could also be linked to the efficiency of the legal system. Although Djankov et al. (2007) found that South Africa had a high credit right index for secured creditors; the World Bank (2003) has suggested a shortage of judges and magistrates, backlog of cases and lower credit protection in practice. This could explain why SMEs behave more ethically when they provide collateral (more efficient legal environment) to banks, while trade creditors, in the absence of collateral, perceive SMEs to be more unethical and the legal system more inefficient.

A final observation is that, although trade creditors do not expect collateral, they regard the “low level of equity contribution of owner” (6.02 versus 6.92 for banks) as being almost equally important for the non-availability of credit to new SMEs. This confirms the importance of the capital structure (sufficient equity) as a prerequisite to obtain debt.

Conclusion

This study has created a unique opportunity to focus on commercial banks (usually secured) and trade creditors (usually unsecured) as the two major providers of external debt to new SMEs. It also provides valuable insight into how collateral influences the importance of ethical behavior of the entrepreneur and the efficiency of the legal system as prerequisites for the availability of credit. Regardless of the limitation that the study was conducted in one province in a developing country (South Africa), it is my opinion that the results explain the critical balance between the availability of credit versus ethics, the legal system and collateral in any country. Previous studies have suggested that creditors rely primarily on hard information in making the credit granting decision. In the absence of hard information, which is typical of new SMEs, the ethical behavior of entrepreneurs should increase their chances of obtaining external debt. However, the efficiency of the legal system influences not only ethical behavior, but also the extent to which debt (secured and unsecured) can be collected.

The research confirmed previous results that external debt is not readily available to new SMEs in developing countries. South Africa scores high in terms of the credit right index, thus giving sufficient protection to secured creditors. However, the inefficiency of the legal system to which the unsecured creditor is exposed leads to different behavior from commercial banks as opposed to trade creditors. Banks rely almost exclusively on collateral to mitigate the information asymmetry and moral hazard of new SMEs. Because the legal system gives banks sufficient protection, they do not have to rely on the ethical behavior of the SME owner. In contrast, the trade creditor, in the absence of collateral, is exposed to an inefficient legal system. The inefficiency of the legal system could further contribute to the unethical behavior of SME owners. Bank loans are therefore not available to new SMEs because banks require collateral, which the typical entrepreneur in a developing country does not have, while trade credit is not available because the inefficiency of the legal system almost promotes unethical behavior.

The question was initially raised whether creditors are to be blamed for the financing problem of new SMEs in developing countries such as South Africa. Given the non-availability of credit from both commercial banks and trade creditors, they do contribute to the problem, but there are mitigating circumstances. It is therefore recommended that the South African government should improve the efficiency of the legal system, protecting not only the secured creditor. An inefficient legal system also promotes unethical behavior. Entrepreneurs have to realize that unethical behavior, combined with the lack of an own equity contribution, jeopardize their access to external debt. In addition, commercial banks, relying almost exclusively on collateral, should focus more on the soft information in their financing decision with regards to new SMEs.

The link between entrepreneurship and economic growth worldwide is common knowledge. The typical entrepreneurs in developing countries lack sufficient own contribution and collateral, which emphasizes the importance of access to external debt from commercial banks and trade creditors for the growth and survival of their new ventures. To create a financing environment that is conducive to new SME development, government should understand the importance of an efficient legal system, and entrepreneurs should recognize the importance of equity contribution and ethical behavior, while banks should rely less on collateral. The complex relationship between ethics, the legal system and collateral could explain, in many countries, the availability of external debt to new SMEs.

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