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# Soft Information, Core Competitive Edge and Private Relationship Lending—A Case of Village Banks

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**Abstract** In view of the development problems of village banks, through introducing the concept of private relationship lending, the functions of soft information, the channels of village banks for collecting soft information, and the private relationship lending of village banks under Chinese rural human environment of highlighting relationship while despising rationality are proved. According to the recognition standard of core competitive edge, it can be concluded that the core competitive edge of village banks is private relationship lending. In the first place, these kinds of small and medium-sized quarter banks have competitive advantages in launching private relationship lending; in the second place, the lending businesses of village banks based on soft information attracts small and medium clients; in the third place, the private relationship lending has realized the scale economy. Furthermore, the reasons why village banks can not display the core competitive edge have been analyzed: firstly, village banks have not found that private relationship lending is their core competitive edge; secondly, the internal motivation on establishing private relationship lending of village banks is insufficient; thirdly, village banks have not prepared well in developing private relationship lending; The relevant policies and countermeasures are put forward, including transforming idea and vigorously developing private relationship lending; intensifying training and improving the quality of personnel involved; strengthening supervision and avoiding the violation behaviors of personnel involved; emulating experiences and perfecting the private relationship lending mechanism of village banks.

**Key words** Soft information, Private relationship lending, Core competitive edge, Village banks, China

As a financial intermediary to effectively solve the asymmetric information, bank can launch trade-based lending according to the hard information of debtors in terms of their financial statement, capital mortgage and credit rating, as well as private relationship lending according to the soft information of debtors including the reputation, morals and behaviors of them. Compared with large banks, the small and medium-sized village banks have the comparative advantages in relationship lending (Scott, 2004)<sup>[1]</sup>. Taking village banks as examples and in view of the development of banks, the paper studies the relations between soft information, core competitive edge and relationship lending. It is pointed out that village banks have not fully displayed their core competitive edge and the countermeasures are put forward, so as to provide theoretical reference and experience evidence for China to cultivate new rural financial intermediaries and promote the reform in increasing the number of rural finance.

## 1 Soft information of village banks and private relationship lending

Soft information refers to the financial statement, capital mortgage and credit rating, which are hard to encode, quantify and transmit compared with hard information. It is a kind of information with strong personalized features. Berger & Udell (2002) thought that soft information can be regarded as the special knowledge of particular debtors collected by banks. It

can replace hard information to a large extent; make up for the credit gap of debtors as a result of failure to provide eligible financial information and mortgage and improve their disadvantaged conditions<sup>[2]</sup>. Bass & Schrooten (2005) found that the soft information collected in the process of performance might produce significant value, which surpasses enterprise financial statement, mortgage and credit score. It was conducive to helping the lenders in relationship lending to solve the opaque information of debtors<sup>[3]</sup>. As community middle and small-sized banks, village banks have the competitive edge in collecting soft information compared with large banks. Soft information collected by village banks includes four kinds, namely, local market situation, business operation of clients, enterprise situation of clients and the restrictions of local informal system.

Relationship lending means the lenders obtain proprietary information (soft information) from debtors from long term contacts and take these information as the basis when providing loans (Aoki, Masahiko *et al.*, 1997; Boot, 2000; Berger & Udell, 2002)<sup>[2, 4-5]</sup>. According to the punishment mechanism of dishonest behaviors, Zhaoge (2008) classified different relationship lending as public relationship lending and private relationship lending. In foreign countries with developed market-oriented economy, the punishment mechanism of dishonest behaviors in economic activities takes the formal legal system as the major basis and the non-formal system achieved among the society and the personnel involved as the supplement, so it is a kind of "public" punishment mechanism. However, in China, the personal trust system of its market-oriented economy is imperfect, which leads to the weakness of China in stipulating formal legal system in terms of punishing dishonesty. In contrast, the role of non-formal system in punishing dishonesty is improved. Besides, the traditional culture of highlighting rela-

Received: August 3, 2011 Accepted: September 25, 2011  
Supported by National Social Science Foundation (10BJY057); 2010 Program of the Eleventh-Five Plan of the Development of Philosophy and Social Science in Guangzhou (10Y49).  
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tionship while devaluating rationality in China further strengthens the role of non-formal system. Therefore, the relationship lending in foreign countries with developed market-oriented economy is public relationship lending, but it is also a kind of private relationship lending. So the private relationship lending is the implementation model of relationship lending in the market-oriented economy of Chinese reality. It will largely rely on human relations in community to solve the credit relations between village banks and customers and it is the essential system of Chinese community-based banks<sup>[6]</sup>.

The private relationship lending of village banks means under Chinese special human and economic environment, the creditor-debtor relations between banks and customers are solved through the social relations of human relations, geographic relations, relative relations, career relations and school relations, the functional mechanism of trust, culture and regulation and the restriction of formal system. The village banks collect the soft information of customers as the major decision-making evidence to decide whether to provide loan, what kind of loan and the sum of loans. Furthermore, after providing the loan, village banks decide whether provides access to follow-up loans according to the feedback of customers. With the assistance of formal system restriction, village banks solve the asymmetric information before providing loans through the soft information collected and the asymmetric information after providing loans by various kinds of non-formal systems of rural communities formed under the influences of Chinese traditional Confucius thoughts. The soft information is taken to ensure the relatively high repayment rate of debtor, which is the private relationship lending mechanism of village banks.

The operation efficiency of private relationship lending of village banks mainly depends on the creditability of soft information, the effective decision of decision-making system and the scientific design of in-house stimulation and supervision system. Soft information is the basis for making decision, as well as the major evidence for designing financial products. By cross-validation method, the loan officers test the effectiveness of the soft information from multiple information sources and multiple dimensions and improve the creditability of soft information. Through checking the soft information and combining the hard information, the decision-making system scientifically evaluates the feasibility of the project, repayment capability and repayment willingness. And then the financial products are designed by taking this as a core and relying on expert to ensure the effective work of the decision-making system. Besides, in the development process of private relationship lending of village banks, as the enforcer of loan procedure, the staff in village banks should scientifically stipulate the internal stimulation and supervision system to ensure effective management, thus, to prevent the lawbreaking activities including cheating, conspiracy *etc.*

## 2 The core competitive edge of village bank is private relationship lending

As a kind of small and medium-sized bank with stock sys-

tem, village bank faces many problems in its development. WANG Shu-guang<sup>[7]</sup>, LIU Song<sup>[8]</sup> and Chengkun<sup>[9]</sup> think that village bank has the problems of insufficient capital source, unclear market position, inadequate business innovation, weak competitive competency, internal personnel control, governmental interference, poor personnel and difficult control on credit risks. Although many literatures have analyzed the developmental problems of village bank and have achieved consensus, the root of the problem has not been seized. We believe that the root of the developmental problems of village banks is that the core competitive edge of private relationship lending on the basis of soft information has not been fully displayed, and then it has not effectively developed in rural areas.

After Prahalad & Hamel putting forward the concept of "core competitive edge" for the first time, many scholars have conducted deep researches on the theory<sup>[10]</sup>. The core competitive edge means enterprises has the capability of developing distinctive products, technology and marketing capability. Displaying the core competitive edge enables enterprises to face fierce market competition and continuously expand and develop in competition<sup>[11]</sup>. Generally, there are three criteria in identifying core competitive edge: whether have the differences in imitating; whether the customers agree and whether can realize scale economy<sup>[12-13]</sup>. As a financial system arrangement which prefers social capital input, the private relationship lending of village bank is in accordance with the three criteria of core competitive advantages, so private relationship lending is the core competitive edge of village bank.

**2.1 Village bank has comparative advantages in launching private relationship lending** The advantage of this kind of small and medium-sized banks such as village enterprise can not be imitated by big banks. De Young & Rice think that big banks establish competitive advantage through scale economy, while small banks establish competitive advantages through building relationship<sup>[14]</sup>. J. P. Suter thinks that the capability of small banks to collect and use soft information is the core competitive edge of them<sup>[15]</sup>. Village bank has greater capability than big banks in collecting and handling soft information. When launching private relationship lending, village banks need lower costs. But the competitive edge of big banks is reflected on the scale effect of issuing large sum of loans and the small loan with small sum of money, frequent loan, and zero mortgages will cost more.

**2.2 The private relationship lending of village banks on the basis of soft information attracts small and medium customers** Compared with big customers, the small and medium customers have the problems of small sum of loan, imperfect financial material and lack of mortgage. The village banks can get to know the real needs of small and medium customers through collecting the soft information of them and according to the repayment capability of small and medium customers to provide the tailored financial services. For one thing, the private relationship lending on the basis of soft information has low demand of the hard information of small and medium customers, so the small and medium customers are easy to get

loan; for another thing, financial services provided by private relationship lending is based on the repayment capability of small and medium customers and the demands of them. Under such situation, the small and medium customers have more capability in getting the follow-up loan. Therefore, small and medium customers prefer the financial services provided by this kind of private relationship lending.

**2.3 The private relationship lending of private and township banks has realized the scope economy** Scale economy is the economy bought by the scope of enterprise rather than scale, that is to say, when the costs of producing two products are lower than producing each kind of product, this kind of situation is called scope economy. Once the cost of producing two products is lower than the cost of producing a single product, there is scope economy. Scope economy is the theory basis of multiple operation strategy adopted by village banks for entering community. The most important thing for forming scope economy is that different products can share common production resources. As for the private relationship lending of village banks, common resources are the soft information collected through long term contact with customers, and then the marketing network of financial services, team of loan officers, risk management system and decision making system. on the basis of the common resources, such as private relationship lending, village banks provide all-around financial services for customers in terms of saving, credit, remittance, lease and financial management, so as to realize scope economy. At present, some village banks put forward the development strategy that enter community to provide 100% services for 20% people is the case of using private relationship lending to realize scope economy.

### 3 Reasons that village bank can not display its core competitive edge

Although at present, a small part of businesses of some village banks have adopted the related technology of private relationship lending consciously or unconsciously, but in general, the village bank has not fully display its core competitive edge. Three reasons are accountable for this.

**3.1 Village banks has not found its core competitiveness as private relationship lending** The relevant stipulations in *The Interim Stipulations of village banks* stipulates that the major senior managers should come from the existing financial institutions of banks. The senior managers from traditional banks are influenced by the traditional thought of banks. In the process of operation, they are easy to follow the traditional operating thought, but ignore the differences between village banks and Chinese traditional banks; therefore, they can not recognize the core competitiveness (private relationship lending) of village banks.

**3.2 Village banks do not have enough internal drive to establish private relationship lending** For one thing, rural financial market lacks competition. At present, there are less competitive main bodies in rural financial market, so the monopoly has been formed. But the village banks have developed

from new comers to one of the financial oligarchs in rural financial market. Under such cases, village banks tend to maintain the current situation. For another thing, the conservative senior managers from village banks do not want to bear the risks and costs of mechanism reform and product innovation. Since 2007, the village banks have run for four years. Affected by traditional ideas, their lending technology is mainly the distance-keeping lending based on hard information and the path reliance has been formed gradually. If establishing private relationship lending as the core competitiveness of village banks, they will inevitably pay some costs for this including rebuilding credit mechanism, innovation of financial products and training of employees.

**3.3 Village banks have not prepared well to develop private relationship lending** For one thing, it is imperative to establish soft information system, decision-making system, internal incentive mechanism, for example, collection, handling, filing, stipulation of making decision, and product design *etc.* For another thing, the quality of staff in village banks should be improved. The research on private relationship banks is backward and the promotion on it is absent, so staff in village banks has little knowledge on private relationship banks and has not mastered the relevant technology of private relationship lending.

## 4 Countermeasures on developing private relationship lending of village banks

As small and medium-sized village banks, under the Chinese rural human content of highlighting relationship while belittling rationality, village banks should be effectively inserted into rural community. In the first place, if inserting rural community, it is easy for village banks to obtain the soft information of customers by using various kinds of human relations, for example through relatives, friends, neighbors and peers of debtors to obtain the soft information of the debtors in terms of personalities, behaviors and social reputations. In the second place, the debtors can easily get loan from banks through private relationship lending. The decision of village banks mainly relies on soft information, so compared with hard information, the hardship of debtors in providing appropriate financial information; mortgage and credit rating report can be improved. In the end, under various restrictions of informal systems for example, village stipulations and rules, the credit default behaviors of debtors can be well restricted. Affected by Chinese Confucius culture, these informal regulations and rules are more powerful than formal ones in many cases. The private relationship lending of village banks is complementary to the intercalation of rural community. For one thing, the intercalation of village banks gives access to private relationship lending. For another thing, developing private relationship lending of village banks can promote the effective intercalation into rural community.

Developing private relationship lending, displaying the core competitiveness of village banks and then effectively inserting into rural community, the following points should be achieved.

**4.1 Transforming ideas and positively developing private relationship lending** The management of village banks

should change the operation ideas of Chinese traditional banks; rightly identify the differences between small and medium-sized village banks and Chinese traditional banks; deeply understand that from long term perspective, displaying the private relationship lending is an important way of reducing costs, improving competitiveness and opening market, and then, innovate and reform bravely and develop private relationship lending vigorously.

**4.2 Intensifying training and improving the quality of personnel involved** village banks should employ experts to train credit officers and teach them the affiliated technology of private relationship lending so as to cultivate credit officers' capabilities in human communication and information screening, at the same time, improve the capabilities of decision-making staff in scientific decision making, analysis and judgment.

**4.3 Strengthening supervision and preventing the default behaviors of personnel involved** In order to prevent the illegal loans or relationship loans of personnel involved, in the first place, various education-based activities should be launched to improve the career moral of personnel involved. In the second place, the internal incentive mechanism should be designed to improve the opportunity costs of personnel involved who violate the laws and regulations. In the third place, the complete and multiple-level internal supervision system should be established to supervise the credit procedures.

**4.4 Perfecting the private relationship lending of village banks by mirroring experiences** The private relationship lending should be launched vigorously to provide tailored financial services for customers through emulating foreign experiences (for example, American village banks) and combining the human character of China.

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and regulations are also key points of farmers' education. It is required to not only let farmers understand basic rural policies and regulations, but also help them to defend their lawful rights and interests by using these policies and regulations.

**3.3.3 Perfect the agro-technical popularization system.** Presently, farmers' longing for agro-technical achievements is stronger than ever before. However, due to low income and limited capital accumulation, farmers are hard to obtain agro-technical achievements that are suitable for their demands. For this reason, it is required to enlarge the capital accumulation; insist on the farmer-oriented principle, closely unite farmers and agricultural research personnel, so as to make the scientific research achievements rapidly change into actual

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productivity, consequently provide technical support for increasing farmers' income.

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