How do manufacturing SMEs obtain loans in China? A culture embeddedness and informal institution perspective

Thesis submitted for the degree of

Doctor of Philosophy

at the University of Leicester

By

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School of Business

University of Leicester

2018

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Abstract

Despite their great contributions to the Chinese economy, large numbers of small and medium-sized enterprises (especially manufacturing SMEs) in China still face significant financing constraints. Due to the opacity of information disclosure, trusted accounting information is not common among small business and SMEs, so they are regarded by external lenders as comparatively risky enterprises, with the result that it is hard for them to obtain funding. This leads to the motivation of this research: if this is the real situation, then how do SMEs obtain loans in China?

In order to address the research objectives, three rounds of fieldwork were conducted in eastern China from 2013 to 2015. A new research tool, the *guanxi*-oriented snowballing method was applied to find the research sample, participant observation was used and twenty in-depth semi-structured interviews were conducted to collect qualitative data. The interviewees comprised staff members of financial institutions (micro-credit company and banks), and manufacturing SME managers. The thematic analysis and Framework Analysis (FA) approaches were adopted to analyse the research data.

Guanxi is a Chinese concept that could not only describe a social tie between people or businesses, but also be considered as a culture tradition, an informal rule and a very important social capital in China. A *guanxi* structure which contains three dimensions and four main features was used to explain and identify *guanxi* in this study. In addition, this research proposes a theoretical framework that contains elements of embeddedness theory and institution theory to frame *guanxi*. The research tries to improve the embeddedness theory by analysing *guanxi* from the aspects of it as both a strong tie and weak tie, and discuss the functions of *guanxi* as an informal rule in compensating formal institution deficiencies during the transition period of China. The research findings show that the level of trust in accounting information is very low in China, and indicate that the importance of financial reports may be attached only to the legitimacy they provide, rather than because they can provide very useful information. Given the situation that accounting information is inaccurate and invalid, the findings also show that non-financial information has greater validity in reflecting the true conditions of SMEs than do financial statements, and *guanxi* plays an essential role in the lending process; it is a "lubricant", a 'catalyst' and a harmoniser. In conclusion, it is proposed in this thesis that SME lending is embedded in *guanxi* in China, which means *guanxi* could affect lending decision-making culturally, instrumentally and institutionally.

Acknowledgements

Firstly, I would like to thank my supervisors who help me a lot in academic and in everyday life. Professor Yuval Millo saw great potentials in me and always made useful comments and gave good feedback for my research. Dr Geoffrey Lightfoot always gave appropriate suggestions and clear directions for my research. Their supervision was really helpful and, just like the polestar, guided me when I lost my way in my research. They are really good people and I am so lucky to have had them as my supervisors; I have learnt a lot from them and they are not only supervisors but also like parents to me. Without them, I would never have been able to make it. Thank you so much, Yuval and Geoff! I also would like to thank Dr Andrea Moro, who helped me a lot at the beginning of my PhD life, although he then went to another university and could no longer be my supervisor.

Secondly, I would like to thank my parents, who raised me and supported me financially and spiritually to finish this study. I am so honoured to be your child. My father always encourages me to be positive and as he always says, "If you have chosen a road, you have to walk till the end of it, no matter how." This supported me to walk down this PhD 'road' all these years. My mother always asks me to be happy and healthy; as she always says, "the other things are all illusions, only happiness and health are real in this life." After all these years since I left home, I hope I can have more time to be with them in the future. I really love them.

Thirdly, I would like to thank my colleagues and friends. I am grateful to Dr Brendan Lambe, my former colleague, module leader, as well as a life-long friend. We have established a great friendship since our teaching cooperation and social interactions. I thank all of my other colleagues, classmates and friends, you know who; we encouraged and supported each other getting through all these difficult years, and I will never forget you guys. Thanks very much.

Finally, I would like to thank my university, the University of Leicester, which provided good facilities and a good environment for my research. I will miss the days and nights here in the FJ student hub. As Charles Dickens wrote, "It was the best of times, it was the worst of times." Anyhow, I am going to face my new era.

Table of Contents

List of Abbreviations

B2B	Business-to-Business
B2G	Business-to-Government
CBRC	China Banking Regulatory Commission
CCB	City Commercial Bank
CCSCDP	China Center for SME Cooperation Development & Promotion
CF	Common Friend
CNY	Chinese Yuan
CRA	Credit Review Approver
CRD	Credit Review Department
EN	Employee Number
FA	Framework Analysis
FS	Financial statement
FSF	Financial Statement Fraud
FSM	Financial Statement Manipulation
JSCB	Joint-Stock Commercial Bank
LM	Loan Manager
MC	Ministry of Commerce
MCC	Micro-Credit Company
MIIT	Ministry of Industry and Information Technology
MSE	Micro and Small Enterprise
NBS	National Bureau of Statistics
NDRC	National Development and Reform Commission
OR	Operating Revenue
PBOC	People's Bank of China
POB	Privately-Owned Bank
SME	Small and Medium-sized Enterprise
SOCB	State-Owned Commercial Bank
SOE	State-Owned Enterprise
TA	Total Assets

Chapter One: Introduction

1.1 Background to Chinese SME's financing

According to the National Bureau of Statistics, China had about 52.51 million small and medium-sized enterprises (SMEs) by the end of 2012, accounting for 99.8 percent of the total number of enterprises in the country. SMEs contribute more than 60 percent of China's GDP, and their contribution to national tax revenue is over 50 percent. SMEs also account for more than 68 percent of China's exports and about 75 percent of the new jobs created nationwide. Despite their great contribution to the Chinese economy, large numbers of SMEs in China still face significant financing constraints, particularly in rural areas. Small enterprises need credit to start up and expand their business and medium enterprises also have market-oriented production credit demands (He, 2008).

Many SMEs are virtually excluded from formal financial services in China. In 2005, the Zhejiang Province Bureau of China Center for SME Cooperation Development & Promotion (CCSCDP) took a credit survey of 592 small enterprises. The result showed that only 28.7% of these small enterprises (with annual sales of less than 5 million CNY) had taken loans from banks, 29.4% of the enterprises had received start-up funds from their friends or relatives, and 14.7% of them had obtained funds from informal lenders (He, 2008). This indicates that the formal financial sector, such as traditional banks, is not the main source of credit for Chinese SMEs. Despite the large volume of assets that state-owned commercial banks (SOCBs) have, Cousin (2011) found that the majority of bank loans from SOCBs were granted to large state-owned enterprises (SOEs), but not to SMEs. This is partially because that the likelihood of being rescued by the government is high when SOEs go bankrupt, which will not normally happen with SMEs, so the risk of making loans to SOEs is always considered lower than to SMEs (Cousin, 2011; Shen *et al.,* 2009). In addition, since SOEs and SOCBs all belong to the state, they share similar administrative structures and organisational styles, so SOCBs may be required by the government to support SOEs, making lending by SOCBs more politically than commercial driven (Cousin, 2011; Park and Sehrt, 2001). Hence, SOEs have more advantages than SMEs in terms of obtaining loans from SOCBs, which

makes it harder for SMEs to obtain finances. Moreover, Beck and Kunt (2006) found the probability of a small enterprise facing financing constraints to be 39%, compared to medium-size enterprises with 36% and large enterprises (mostly state-owned) with 32%. Chan *et al.* (2012) also had similar findings from a sample of 1271 listed firms from the Shanghai and Shenzhen stock markets. This indicates that lack of access to finance is an important obstacle for SMEs in the process of start-up and expansion. Hence, SMEs are more constrained by the financing problems than are large enterprises (mainly SOEs). Therefore, both the Chinese government and academia have paid great attention to the questions of how these obstacles and financial constraints occur and how these problems can be solved. These questions are important since they can have great implications for the development of Chinese SMEs and thus affect the economic development of the whole country.

The main reasons for this situation are: information asymmetry problem; no collateral; no contact or connection with formal financial institutions (Zhao, 2011). Collateral is commonly used in lending; however, since many banks only accept housing properties or land as collaterals, but most Chinese SMEs are not able to provide these, particularly in their start-up stage, this adds to the exclusion of SMEs are more excluded from banks, and SOCBs in particular (Talavera *et al.,* 2012; Wu *et al.,* 2008). Apart from the lack of fixed assets as collaterals which limits SMEs' access to bank loans (Shen *et al.,* 2009; Yeung, 2009), the information asymmetry problem is reflected in problems such as opaque ownership structure, 'unsystematic management' and unreliable information disclosure (Beck and Kunt, 2006; Zhe and Yang, 2010; Yeung, 2009: 293). The information disclosure problem is related to the invalidity and inaccuracy of the accounting information of many SMEs. Normally, accounting information such as financial statements is used to inform investors or lenders about the finances of a company, which means that interested parties should be able to rely on this 'technical' and 'independent' verification (Robinson *et al*., 2015), namely, 'decision-usefulness' (Maynard, 2017: 5). While accounting information is still often seen as the most reliable method of conveying a company's financial circumstances, there remains some scepticism about it (Gerard, 2012). Jones (2011) asserts that creative accounting, accounting fraud and accounting scandals are frequent occurrences worldwide. This

situation pertains in China. The truth of financial statements is always questionable in China too, because accounting scandals such as financial statement frauds (FSF) or financial statement manipulation (FSM) are also very common in China (Xuan, 2002; Wu, 2002; Chen *et al.,* 2011a), and the number of corporate scandals has been increasing due to this phenomenon (Michael *et al.,* 2005). The number of reported fraudulent financial statements has been being increasing and has shocked the public, with even many listed companies in China involved in this tide (Xuan, 2002; Chen *et al*., 2011a).

Therefore according to these studies, since SMEs are typically not able to show their creditworthiness and strength (because they usually do not have enough collateral) as can large enterprises, they are always regarded as more risky enterprises by suppliers of external funds, with the result that it is hard for them to obtain fund. Thus, in order to show that they are in good condition and then obtain more funds from external financing providers, SMEs manipulate financial statements such as by overstating assets or understating liabilities, since these statements are demanded by financial institutions, particularly banks, before lending. However, such behavior exacerbates the situation worse since banks will distrust SMEs more if they find these statements are manipulated, resulting in SMEs becoming more opaque in terms of information disclosure, which finally leads to a vicious circle and makes it even more difficult for SMEs to obtain funding in China. So questions arise here: If the reality does reflect this scenario (i.e. SMEs' financial statements are not trustworthy or reliable) in China, then how do Chinese SMEs obtain loans? How do Chinese financial institutions make lending decisions? This thesis tries to answer these questions, and which is also the motivation of the research.

Before entering into the core topics of this thesis, it is also necessary to introduce some background information about current SME lending in China. Hence, section 1.2 provides some background information about Chinese financial institutions and SMEs. It first introduces the definition and distribution of Chinese SMEs, and then turns to the evolution of the Chinese banking industry, also showing the types and number of financial institutions in China. Section 1.3 presents the structure of the whole thesis.

1.2 Chinese financial system background

1.2.1 Definition and distribution of SMEs in China

In 2011, four Chinese government departments, the Ministry of Industry and Information Technology (MIIT), the National Bureau of Statistics (NBS), the Ministry of Commerce (MC) and the National Development and Reform Commission (NDRC), jointly announced the 'Regulations on Small and Medium-sized Enterprises (SMEs) Classification Criteria'. According to the "Regulations", Chinese SMEs are divided into three categories: medium-sized enterprises, small enterprises and micro enterprises. In addition, there are 16 industry categories of SMEs; for example, the manufacturing industry, architecture industry, and so on. The detailed classification standards of Chinese SMEs are based on different industries and depend on indicators such as annual operating revenue, number of employees and total assets. For example, manufacturing SMEs are defined as companies with employees of less than 1000 and annual operating revenue of less than 400 million CNY. The details are shown in table 1.1 in the appendix.

It can be seen from table 1.1 that different industries have different classification standards for SMEs. The subjects of the research in this present study are mainly manufacturing SMEs, so taking the manufacturing industry as an example, enterprises meeting one of the following two conditions are all considered as small and medium-sized manufacturing enterprises: with fewer than one thousand employees or an operating revenue of less than four hundred million CNY. Moreover, enterprises employing three hundred people or more and with an operating revenue of not less than twenty million CNY are considered as medium-sized enterprises; those with at least twenty but fewer than three hundred employees and an operating revenue of not less than three million CNY are treated as small enterprises, while those with fewer than twenty employees and an operating revenue of less than three million CNY are treated as micro enterprises. This is the classification of manufacturing SMEs for the whole country.

Table 1.1 shows the national classification of SMEs, while it is known from the research data that different banks might have different classifications according to their own credit policies, requirements and conditions. For example,

"As a stated-owned bank, our classification is roughly like this: enterprises with a loan amount below 30 million CNY and annual sales below 100 million are considered as SMEs, while some small commercial banks may consider enterprises, which have only 10 million CNY loans, as large enterprises." (LM9: Transcript 9, P.2)

"Enterprises (with loan amount) above 10 million and below 50 million are SMEs normally… another classification is micro and small enterprises (MSE), where the net of the customer's in-home tangible assets should not be less than 50 thousand CNY. [Net tangible assets include real estate without loan, automobiles etc.]… But there may be some intersection between SMEs and MSEs here, since some of the MSEs may also have loans above 10 million CNY." (LM2: Transcript 2, P.1, 2)

"Enterprises with sales figures under 30 million CNY and registered capital of under 6 million CNY are small enterprises… above 30 million and 6 million CNY are medium-sized enterprise" (LM4: Transcript 4a, P.18)

As can be seen from the above quotations, some indicators used by banks to classify SMEs are different from those in the national "Regulations". For example, LM9 from a state-owned bank uses loan amount and annual sales to classify SMEs, LM2 from a joint-stock commercial bank uses loan amount and net tangible assets to classify enterprises, while LM4 from a city commercial bank uses sales figures and registered capital to classify enterprises. Thus it can be seen that different banks in China have their own specific classifications of SMEs in practice, rather than simply going by the official classification criteria.

Concerning geographic distribution, 68.6 percent of SMEs are located in the eastern part of China, 20.1 percent in the central area, and 11.3 percent in the western part. The top five regions in the eastern China famous for their huge number of SMEs are Jiangsu province, Zhejiang province, Guangdong province, Shandong province and Shanghai City. These five regions account for about 48.4 percent of all SMEs in the whole country. Concerning the industry distribution of Chinese SMEs, the manufacturing industry contributes more than half of the total SME business revenues (accounting for 52.8 percent), the wholesale and retail industry contributes 35.2 percent, the construction industry accounts for 4.6 percent, and the transportation and storage industry contributes 2.6 percent (Liu, 2008, data from the 1st China Economic Census). As can be seen from

these data, the eastern part of China (particularly the five regions) is home to most of the SMEs in the country, and the manufacturing SMEs play a very important role in the economic contribution. The subjects of this research are also SMEs located in eastern part of China.

1.2.2 Background to the Chinese banking industry

As this research is mainly about banks and SMEs in China, it is necessary to introduce the history of the evolution of Chinese finance industry, especially the banking sector. After the Chinese economic reform in 1978, the first bank, the Agricultural Bank of China, was established in 1979 by the central government to support agricultural development. Then, in the same year, the Bank of China and the China Construction Bank were also established. In 1983, the People's Bank of China (PBOC) became the central bank of China, and the Industrial and Commercial Bank of China was founded to support business activities in China. The establishment of joint-stock commercial banks began in 1986, and city cooperatives and city cooperative banks have been developed into city commercial banks since 1992 (Shen *et al.,* 2009). According to the Central Bank Law published in 1995, a "three-tier banking structure"[1] was built and the PBOC was given independent monetary policies making it autonomous (Li and Liu 2001-b: 248). The Chinese banking sector developed rapidly after this. In 2001, the PBOC proposed the policy "Interim provision for brokerage business of commercial banks", which liberated commercial banks from limitations in doing such business as financial derivative business, investment fund custody and so on, which had previously been strictly restricted in these banks. The announcement of the policy meant that Chinese commercial banks were allowed to engage in investment banking business after the approval of the PBOC; it also meant that China's banking sector had entered into the era of mixed operation. In 2003, China Banking Regulatory Commission (CBRC) was established to supervise banks, asset management companies, trust and investment corporations and other types of deposit-related financial institutions, with the intention

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[1] The structure includes three policy banks (The Agricultural Development Bank of China; China Development Bank and Export-Import Bank of China), four state-owned commercial banks (Bank of China, China Construction Bank, Agricultural Bank of China and Industrial and Commercial Bank of China), and other nonstate-owned commercial banks.

of maintaining the legal and steady operation of the banking industry in China. In 2006, state-owned commercial banks (SOCBs) began joint-stock reform, and the government wanted to release part of bank shares to external investors. In 2008, the China Development Bank was transformed from a policy bank into a joint-stock commercial bank (JSCB). In 2009, the last SOCB, the Agricultural Bank of China, finished its joint-stock reform after the other three. After the reform, these SOCBs were not owned solely by the government. (Data from the Almanac of China's Finance and Banking, CD ROM, 1995-2011).

According to the 2015 annual report of China Banking Regulatory Commission (CBRC, 2015), by the end of 2015, there were 5 large state-owned commercial banks (the 'big five' SOCBs), 133 city commercial banks (CCBs), 12 joint-stock commercial banks (JSCBs), 3 policy and national development banks, 5 privately-owned banks (POBs), 1373 rural credit cooperatives, 859 rural commercial banks and 71 rural cooperative banks in the Chinese banking system. Based on the data from CBRC (2015), the 'big five' SOCBs account for 43 percent of the whole assets of the above six types. The POB type was excluded from the calculation because these 5 POBs were established only 2014, so there are not enough data on their total assets. As a supplementary financing resource for SMEs, micro-credit companies (MCCs) are considered as non-banking financial institutions in China since they are not able to absorb public deposits. In 2005, the PBOC conducted an experimental project in five pilot provinces, which encouraged private capital to establish MCCs to support small business there. The project was then promoted to the whole country in 2008, after the issue of Guidelines on the Establishment of a Microcredit Company (CBRC 2008, No. 23) by the PBOC and CBRC (Du, 2008). According to a statistical report about MCCs announced by PBOC, there were 8673 MCCs in total in China by the end of 2016, and the total loan amount granted to SMEs was about 927.28 billion CNY, so MCCs have contributed a great deal to the development of SMEs in China.

1.3 Thesis structure

There are nine chapters in this thesis. Chapter one, the introduction chapter, associates the fraudulent accounting information problem with that of Chinese SMEs lending. From the literature, the former is supposed to be an important reason why SMEs are facing financial constraints in China. Hence, this research seeks to discover if the real situation corresponds to the findings of previous literature. If this is the case, then how do Chinese SMEs obtain funding, and how do traditional Chinese financial institutions make lending decisions? This thesis attempts to answer these questions, which is also the motivation of the research. Apart from the presentation of the motivation, the first chapter also presents background information about Chinese SMEs, such as the definition and distribution of SMEs in China; and the history of Chinese banking industry and its current situation. Overall, this chapter gives a brief introduction to the background of the subjects of the research (SMEs and traditional financial organisations in China), identifies the motivations for this thesis, and serves as a basis for the subsequent chapters.

The second chapter is the literature review chapter, which presents literature on one important non-financial factor, *guanxi*, which could be considered as the social network, social relation, social capital or informal rule in the Chinese context, but is more complex than that. Beginning by giving the definition of *guanxi*, this chapter first presents the types and strengths of *guanxi*, then explains three dimensions and four main features of the *guanxi* structure in detail. Based on the three dimensions: *renqing* (favors), *ganqing* (feelings) and *xinren* (trustworthiness), and four [2] main features: transferable, reciprocal, empathy and utilitarian, as explained, this thesis uses this structure to analyze *guanxi* culturally and instrumentally. The theoretical framework, is a further section of this chapter, and involves the embeddedness theory, the institution and institution change theory, as well as other concepts such as social capital and social network. Thus, this research combines the new institutional economics and new economic sociology to some extent and extends these two research areas.

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[2] There should be six features in total, as well as another two new ones (exclusiveness and indirectness) found from the empirical data, as will be discussed in the discussion chapter.

The third chapter is the methodology chapter, which first presents the philosophical background of this study. Some epistemological and ontological positions (i.e. interpretivism and constructionism) are explained, as well as their influences on this research. In addition, the Chinese philosophy Confucianism is also introduced since it gave rise to *guanxi*. Second, the cultural and historical embeddedness of latent (informal) rules and *guanxi* in China are presented, which are the foundations of this *guanxi* research. Thirdly, it explains that how the research data are sampled and collected through methods like *guanxi*-oriented snowballing, ethnography, participant observation and interviewing. Then it explains that data are analysed through the thematic analysis and Framework Analysis (FA) approaches. Finally, some reflections about this research are presented.

The empirical research data is divided into four data analysis chapters. Chapter Four presents the current accounting information environment of SME lending, and seeks to explore the causes and incentives of this environment. In the situation presented in Chapter Four, that the level of trust in accounting information, such as financial statements, is very low in China, Chapter Five mainly discusses how financial institutions make lending decisions based on non-financial information. Chapter Six seeks to show the implementation of *guanxi*, which is another important non-financial factor in the lending process and finds that *guanxi* has many functions in SME lending; for example, it could be used to investigate borrowers smooth the way on the lending process. Chapter Seven shows that *guanxi* could affect decision-making and there is clearly also a dark side related to it.

Chapter Eight is the discussion chapter. Briefly, it discusses *guanxi* as a social capital and informal rule in China, which is embedded deeply in the Chinese culture and society. Therefore, the embeddedness theory will be used to explore in depth how SME lending is embedded in *guanxi* culturally and instrumentally. The institutions and institution change theory is used to analyse how *guanxi* became supplementary to formal rules, and its institutional change during the economic transition period of China.

Chapter Nine is the conclusion chapter in which key research findings will be

summarised. Empirical, theoretical and methodological contributions of this thesis will be concluded and the research questions will be answered finally in this chapter. In addition, some implications for the improvement of the SME lending area in China will also be presented, as well as limitations of this research.

Chapter Two: Literature Review

In order to solve the problems (i.e. the information asymmetry problem) in SME lending mentioned in Chapter 1, previous research mainly focuses on the application of lending technologies (Berger and Udell, 2002, 2006; Uchida *et al.,* 2008; Navajas *et al.,* 2003). For example, Berger and Udell (2002) divided small business-lending technologies into four main categories: financial statement lending, credit scoring, asset-based lending and relationship lending. The first three are based more on financial information, while the last is based on non-financial information. Financial information refers to financial data that can be recorded easily, e.g. in the form of numbers, financial statements, reports and so on, while non-financial information refers to information which is hard to record, e.g. the relationship between the lender and borrower. Relationship lending focuses on the importance of non-financial information and relationship (long-term normally) between bank and borrower, which could be used effectively to overcome the information asymmetry problem (Udell, 2008; Degryse and Van Cayseele, 2000; Boot, 2000). However, few researchers pay attention to the possibility of *guanxi*, which could be simply considered as relationships in the Chinese context, but is more complex than that, and is also a cultural phenomenon, tradition and social capital in China, in solving these problems. Hence, this research intends primarily to study the impacts of non-financial information and informal institutions such as *guanxi* on Chinese SME lending. This research tests the effects of *guanxi* in the process of making loans, and determines whether it can be applied as an efficient approach to reduce problems such as information asymmetry for Chinese SMEs. Before explaining how *guanxi* could affect lending, the Chinese concept and structure of *guanxi* should first be introduced.

2.1 Concept of *Guanxi*

Generally, *guanxi* can be translated as 'relationship' in English, but it is more than relationship. Many researchers have studied *guanxi* from the perspective of a cultural or social phenomenon (Huang *et al.,* 2013; Dunfee and Warren, 2001; Chen *et al.,* 2013). Chen *et al.* (2013) believe that Chinese *guanxi* is a complex social phenomenon which can be understood through multiple perspective levels of analyses. For example, it can

refer to a *guanxi* person, a related state (connection) between two or more objects (the objects can be animate or inanimate) or a *guanxi* net (Bian, 1994; Chen, Chen and Huang, 2013). Other researchers state that *guanxi* has existed in China for over two thousand years and is deeply rooted and embedded in Chinese society and culture (Gong *et al.,* 2013; Luo, 1997). Tsang (1998) contends that *guanxi* exists to some extent in every society, but it is of considerable importance in China since it plays a significant role in Chinese daily life. Chinese society is a *guanxi* society (Troilo and Zhang, 2012). Boisot and Child (1996) consider *guanxi* to be the label of Chinese business to some extent. Fan (2002) also believes that *guanxi* is a very important factor in business operations in China and can bring many benefits such as "securing rare resources, bypassing or short-cutting the bureaucratic maze, obtaining information and privilege, selling otherwise unsellable good, providing insurance against uncertainty and assistance when problems arose" (Fan, 2002: 544). Davies *et al.* (1995) argue that the main benefit of *guanxi* is to obtain "insider" information about government policies and gain otherwise unavailable business opportunities. Lovett *et al.* (1999) found that a *guanxi* network can reduce the transaction costs and improve efficiency. Huang *et al.,* (2013) suggest that a *guanxi*-based business could reduce uncertainty, and lower search and transaction costs between business partners. From previous literature, it can be seen that *guanxi* has the potential to solve the information asymmetry problem; for example, in the area of SME lending, the fund providers will not treat their borrowers as risky with it. In addition, *guanxi* could also be probably used as an efficient approach by SMEs to improve their borrowing, since it has benefits such as smoothing the lending process and reducing transaction costs. However, *guanxi* is a double-edged sword; it also has dark side. For example, it may have negative effects such as corruption (Fan, 2002), collective biases (Wellman, 1988), and a domino effect when a *guanxi* network fails (Uzzi, 1997). Moroever, *guanxi* may also lower the efficiency of social resource allocation, such as when one obtains a loan from a bank whose relative is the loan manager or one's child is employed due to a social friendship. In these situations, capital may not be put to an efficient use and a better candidate may not obtain a job, which leads to the inefficient allocation of social resources (Dunfee and Warren, 2001).Thus, according to previous literature, *guanxi* is considered as a social phenomenon, culture tradition, an informal rule, a piece of non-financial information and a very important

social capital that affects business activities such as SME lending in China (Dunning and Kim, 2007; Zhang and Zhang, 2006; etc.).

2.1.1 Defintions of *guanxi*

Guanxi is a common concept in Chinese society and describes a social tie between people or businesses. The Chinese word *guanxi* (pronounced as *kuan-hsi*) consists of two characters: "*guan*" (关) and "*xi*" (系). The first character "*guan*" as a noun means "barrier", and as a verb means "turn off" or "close". The second character "*xi*" as a noun means "department" or "system", and as a verb means "link" or "tie" (Fan, 2002). The most recent edition of the Modern Chinese Dictionary (2012) gives six explanations of *guanxi*: (1) a state of mutual impact or interaction among things, (2) a specific type of connection between two parties or two people, (3) the importance of something which is worthy of attention, (4) referring to causal relationship, (5) a certain kind of organisational relationship certificate, (6) a link or involvement.

In view of the complexity and richness of the Chinese language (Yang, 1994), *guanxi* cannot be explained in just one sentence or by a few words in the dictionary. Wang (2007) suggests that *guanxi* consists of "gate" and "connect"; that is, one must pass the gate to establish a connection with other people. Huang *et al.* (2013) define *guanxi* as a personal connection that follows an inherent psychological contract in the form of some specific social norms. Osland (1990) considers *guanxi* to be "a special relationship between a person who needs something and a person who has the ability to give something" (p.8). Lin (2011) defines *guanxi* as the interpersonal network of reciprocal bonds. *Guanxi* has also been referred to as social behaviour of using personal relationships to get through life or obtain work (e.g., Chen, Chen and Xin, 2004; Xin and Pearce, 1996), or as a strategy for organisations to gain advantages over their competitors (Park and Luo, 2001). Fan (2002) defines business *guanxi* (or organisational *guanxi*) as "the process of finding business (rather than personal) solutions through personal connections" (p. 551). Therefore, *guanxi* is a social connection or relationship that could be used to seek mutual benefits and interests (Bian, 1994; Gold *et al.,* 2002).

2.1.2 Types of *guanxi*

Before researching the impacts of *guanxi* on SME lending, it is important to classify the types of *guanxi*, since different *guanxi* could have distinct impacts on individuals and organisations (Zhang and Zhang, 2006). According to the literature, different researchers have identified various typologies of *guanxi*. Tsang (1998) considers that there are two kinds of *guanxi*: individual level *guanxi* and organisational level *guanxi*; this present thesis also studies *guanxi* within this framework at these two levels. Tsang (1998) also discussed the connection between individual *guanxi* and organisational *guanxi*. He considered organisational *guanxi* to be based on individual *guanxi*. The reason is that it is human beings who implement all the business activities; thus, the strength of organisational *guanxi* between two companies is affected by the strength of their employees' *guanxi* (Tsang, 1998). Leung and Yeung (1995) interviewed some small business managers in Hong Kong and found that business relationships in China always start from individual *guanxi*. Conversely, in the West business relationships may lead to personal relationships (Snehota and Hakansson, 1995). Hence, the *guanxi* between banks and SMEs (which is organisational *guanxi*) can be reflected and measured by the *guanxi* between the LMs and the SMEs' managers (which is individual *guanxi*) in this research.

Furthermore, the existence of *guanxi* depends on the bases of the *guanxi,* which are divided into blood bases and social bases (Tsang, 1998). From the aspect of individual level *guanxi*, the blood bases include family members and relatives. Family blood-based *guanxi* is the most important *guanxi* in China since the family is the foundation of Chinese society (Tsang 1998). Social bases mainly arise from social interactions such as those with classmates, colleagues and so on. The research targets (LMs and SME managers) in this thesis have mainly socially-based *guanxi* since they normally do not have any kinship with each other. Tsang (1998) also gives a clear example of how social-based *guanxi* is established between two strangers:

> "If person A wants to make a request of person C, with whom he does not have
> any *guanxi*, he may seek out a member of his *guanxi* network, B, who also has

guanxi with C, and ask B to introduce him to C. By doing so, a *guanxi* base is established between A and C" (p. 65).

Bian (1994) classified personal level *guanxi* into three types: (a) indirect relationship or "*jianjie guanxi*" (间接 关系), which means "the existence of a relationship between people who share a status group or who are related to a common person" (p. 974), e.g. if A and B do not know each other, but they both know C separately, then there exist *jianjie guanxi* between A and B; (b) direct relationship or "*zhijie guanxi*" (直接 关系), which refers to a direct connection between people, e.g. if A and B know each other and are good friends, then there exist *zhijie guanxi* between A and B; (c) a contact *guanxi* person or "*guanxi hu*" (关系 户), which indicates "actual people with whom one has a strong connection" (p. 975). Bian's classification of personal *guanxi* is based on the type of connections between individuals, but not on the nature of *guanxi*. Some other scholars have proposed types of *guanxi* based on its nature. As cited by Su and Littlefield (2001), Yang (1993) divided individual *guanxi* into three kinds: (1) *jiaren guanxi* (家人 关系), which means the relationship between family members, e.g. the *guanxi* between parents and children, and brothers and sisters are all *jiaren guanxi*; (2) *shuren³ guanxi* (熟人 关系), which means the relationship with acquaintances. The acquaintances include relatives who are in the same clan, or other friend-type such as classmate, colleagues and even well-known neighbours, and; (3) *shengren guanxi* (生 人 关系), which means the relationship with strangers or mere acquaintances. According to this classification, the types of *guanxi* shown in this research are mainly *shuren guanxi* and *shengren guanxi*. This classification is in fact an extension of the blood-based and social-based *guanxi*, dividing these two types into more specific categories.

Hwang (1987) classified interpersonal *guanxi* into three kinds: the expressive tie, the instrumental tie and the mix tie. The expressive tie means a stable *guanxi*; it refers

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³ The original citation in Su and Littlefield's paper was *shou-ren*, but this is an error; the correct spell should be *shuren*. Since sometimes the same Chinese word may have different pronunciations, this leads to different spelling.

mainly to the *guanxi* between family members, close friends and other acquaintances. This kind of *guanxi* usually does not have a purpose and people just gather instinctively. Conversely, people use instrumental ties as an approach to achieve their goals. Therefore the instrumental tie always involves an exchange of benefits exchange and is usually unstable. For example, the relationship between seller and buyer, waiter and customer in a restaurant, taxi driver and passenger are all instrumental ties. The mixed tie is a relationship that is maintained by *renqing* (the definition of which is given in sub-section 2.2.1). Although people who are involved in the mixed tie include some expressive components in their relationship, it is weaker than the expressive tie. This kind of *guanxi* may occur among classmates, colleagues or neighbours who share the same background. Furthermore, the mixed tie is also different from the instrumental tie. The participants in the instrumental tie will rarely meet each other again after the goals are achieved, while people with a mixed tie will continue this relationship since it is based on *renqing*.

Zhuang and Xi (2003) conclude that there are four basic types of personal *guanxi*: inherent *guanxi*, embedded *guanxi*, emerging *guanxi* and developed *guanxi*. Inherent *guanxi* comes when people are born. It can be family *guanxi* with their parents or relatives, their parents' social *guanxi* with close friends and so on. Any *guanxi* that can be inherited from elder generations of the family are all known as inherent *guanxi*. Embedded *guanxi* refers to social *guanxi*, which means the social connection with others in the society, or someone who has to interact with others in the society due to his social position. For example, one's *guanxi* with his/her classmates as a student, with colleagues as an officer or even with neighbours are all embedded or social *guanxi*. Emerging *guanxi* means the kind of *guanxi* that emerges gradually in one's daily life. For example, it can be the *guanxi* process of two persons going from strangers to close friends. This kind of *guanxi* does not have a purpose, but just occurs naturally. In contrast, developed *guanxi* has some kind of purpose behind its emergence. For example, the partnership between businessmen is also a kind of developed *guanxi*. They want only to exchange favours or benefits with each other. Thus, inherent *guanxi*, embedded *guanxi* and emerging *guanxi* are non-instrumental *guanxi*, while developed *guanxi* is instrumental with a purpose. Zhuang and Xi (2003) also think that these four

kinds of *guanxi* are mutually transferrable and overlapping. For example, person A's friends and colleagues are embedded *guanxi* to him, but to A's children, they are inherent *guanxi*; classmates become lovers (embedded *guanxi* transfers into emerging *guanxi*); business partners become good friends (developed *guanxi* transfers into embedded *guanxi*).

As can be seen, different researchers have different classifications of *guanxi*. The Chinese word *guanxi* here refers to a related state between two or more objects; the objects can be human or non-human, animate or inanimate. There are many classifications of *guanxi* types. For example, in terms of its nature, *guanxi* could be individual level and organisational level, could be blood-based and social-based. From the instrumental perspective, *guanxi* could be expressive, instrumental tie or mix type. This research concerns the *guanxi* between banks and SMEs in China, this kind of business *guanxi* is more complex than family or friend *guanxi*. The SME-bank *guanxi* is mainly reflected by the *guanxi* between entrepreneurs and LMs. So one main purpose of this sub-section is to let the readers have a better understanding of *guanxi*.

2.1.3 Strength (or quality) of *guanxi*

The literature above presents the definition and types of *guanxi*, but how can *guanxi* strength be defined and measured? Normally, a high level of *guanxi* between two people usually means they are good friends (Alston, 1989) or that they can benefit from each other (Pye, 1982). It is difficult to identify what strong, medium and weak *guanxi* are in words alone, but for clarification, some examples are provided in table 2.1 in the appendix.

From table 2.1, it can be seen that family *guanxi* is inherited, while family-like friendship between old friends and acquaintances is another kind of strong *guanxi*. Both of them have strong (or high level) *guanxi*, which is stable and permanent, with the *guanxi* members having a high level of trust in each other. The medium level *guanxi* may occur among classmates, colleagues or neighbors who share the same background. Strangers and new friends have weak (or low level) *guanxi*; this kind of *guanxi* may occur when people meet each other for the first time. It is unstable and temporary, with

those concerned only meeting for an instrumental purpose. The strength of medium level *guanxi* varies between strong and weak *guanxi*. Based on Su and Littlefield (2001) and Yang's (1993) classification, *jiaren guanxi* is strong or high level *guanxi*, while *Shuren guanxi* could be either strong or medium, and *Shengren guanxi* is weak and low level *guanxi*. Taking a very practical example to show *guanxi* quality: When you want to borrow money from others, it is more likely that you will be able to borrow it from your parents or good friends than from strangers. It is because that your parents and good friends have high level *guanxi* with you and they trust you. This example shows the *guanxi* between you and your family is stronger (or higher) than other types.

Furthermore, *guanxi* strength is evolutionary. Dunfee and Warren (2001) argue that the establishment of strong *guanxi* does not depend only on the *guanxi* base. For example, classmates (medium level *guanxi*) can evolve into close friends (high level *guanxi*) after a number of years' interaction. New friends (first time meeting with each other) can evolve into ordinary friends (medium level *guanxi*) or even close friends (high level *guanxi*) after a period of interaction. At the same time, *guanxi* is also degradable; high level *guanxi* can degrade to low level *guanxi* if the *guanxi* bodies do not maintain it. In order to build and maintain a trustworthy *guanxi*, individuals or organisations must interact with each other often by exchanging favours, working over time and so on. Similarly, Tsang (1998) claims that it is easy to build a *guanxi* base but that it takes time to develop it: "time, money and effort are required for creating and maintaining social *guanxi*" (p.67). Hwang (1987) concluded that giving gifts and holding a banquet are two mostly commonly used methods in enhancing *guanxi* in Chinese society. Apart from giving gifts and favours, Su and Littlefield (2001) also mentioned some strategies that could be used to improve *guanxi* quality: "…show understanding or sympathy to troubled people, give face by showing modesty, or use an intermediary" (p.202). Therefore according to the literature, except for high level *guanxi*, other levels of *guanxi* all need to be maintained, otherwise, it may not last long. This section describes the strength or quality of *guanxi*, but is there any method to measure or observe *guanxi*? The following section tries to answer this question.

2.2 Structure of *Guanxi*

Most of the researches on *guanxi* are conceptual and rarely include empirical testing, so this research aims to fill this gap. In this project, the role *guanxi* plays in Chinese SMEs for obtaining loans will be examined in terms of the *guanxi* structure as follows. The originality of this research is based on the primary data; the researcher attempts to test the role of *guanxi* between banks and SMEs in China. Before studying the *guanxi* effect between banks and SMEs, it is necessary to take the dimensions and features of *guanxi* structure into account here.

2.2.1 Dimensions of *guanxi*

Previous literature indicates that there are three main dimensions of *guanxi*: *renqing*, *ganqing* and *xinren* (Pye, 1986; Hwang, 1987; Yang, 1994; Xin and Pearce, 1996). Kipnis (1997) suggests that these identifiable elements can be used to observe and measure *guanxi*. Based on these three dimensions, Yen *et al.,* (2011) developed a multi-dimensional measurement, the GRX (Ganqing-Renqing-Xinren) scale model, to measure *guanxi*. This research would not apply this model but would analyze the role of *guanxi* in the credit availability of Chinese SMEs from these three dimensions. The definitions and explanations about these three elements are presented as follows:

Renqing:

The Chinese word *renqing* (pronounced as *jen-chi'ing*) consists of two characters "*ren*" (人) and "*qing*" (情). The first character "*ren*" means "person" or "human beings". The second character "*qing*" means emotions such as happiness, sadness, anger, fear and so on. There are four meanings of *renqing* according to the Modern Chinese Dictionary (2012): (1) human sensibility, such as sympathy; (2) favour; and (3) cultural customs in Chinese interpersonal relationships. For example, if person A is getting married, then as his relative, person B has to give him a small amount of money (the larger the amount of the money given, the closer the *guanxi* between them). In return, when person B is getting married, person A also has to give money to him or her. This kind of process is called *renqing* or '*renqing shigu*' (人情世故) in China; (4) gift.

Hwang (1987) proposes three different definitions of *renqing* in Chinese culture: "First, *renqing* indicates the emotional responses of an individual confronting the various situations of daily life" (p.953). Hwang considers that an individual who knows *renqing* should have empathy; he or she should be able to understand other people's emotional responses to life and try to respond appropriately to them. For example, if person A is sympathetic to other people's feelings and always ready to help others even if not told to do so, then we may say this person possesses *renqing*. "Second, *renqing* means a resource that an individual can present to another person as a gift in the course of social exchange" (Hwang, 1987: 954). In Chinese culture, when an individual has great difficulties (such as a serious illness) or happy events (such as marriage), all his or her relatives and friends are supposed to offer help or give gifts, as the case may be. By this, it is said that his acquaintances are sending him *renqing* and he or she owes them *renqing*. Thus, *renqing* is a kind of resource in social exchange in such cases. "Third, *renqing* connotes a set of social norms by which one has to abide in order to get along well with other people in Chinese society" (Hwang, 1987: 954). This means that in order to maintain his or her social network, an individual should always keep in touch with acquaintances by visiting them from time to time, exchanging gifts and so on. Wang (2007) defines the meaning of *renqing* as exchanges of favour following two social obligation rules, which are the reciprocity and empathy (details of these two rules will be discussed in next sub-section about *guanxi* features). Another important definition of *renqing*, '*renqing shigu*' (人情世故), was translated by Guo and Miller (2010) as social etiquette, while Ruan (2017) translated it as *renqing* and sophistication. However, a new definition of it is given in this present research (see Chapter7, section 7.3)

Ganqing:

Ganqing (pronounced *kan-ch'ing*) consists of two characters "*gan*" (感) and "*qing*" (情). The first character "*gan*" means "feelings" as a noun or "to feel" as a verb. The meaning of the second character "*qing*" is the same as explained in "*renqing*" before. According to the Modern Chinese Dictionary (2012), there are two meanings of *ganqing*: (1) A strong emotional response to external stimuli. For example, if someone likes to eat

chocolates, then the process of eating chocolates will make him happy; (2) a feeling of affection towards someone or something. For example, he likes chocolates.

Chen and Chen (2004) define *ganqing* as "the degree of emotional understanding and connection, and the sharing of feelings of happiness and fears alike. In addition, it refers to a sense of loyalty and solidarity, the willingness to take care of each other under all circumstances" (p. 314). This means that *ganqing* can reflect the closeness of *guanxi* between two parties. For example, A and B have *ganqing,* this implies that they share the same feelings and there exists a *guanxi* tie between them. If A and B have deep *ganqing*, this usually means the degree of emotional understanding between them is deep, and thus their *guanxi* is strong (Chen and Chen, 2004).

Tsang (1998) considers that *ganqing* is a key element in determining the quality of *guanxi*, which can measure the emotional strength between parties to *guanxi*. He also believes that it is easy to build *ganqing*; people who share the same background (such as classmates) can easily have *ganqing*. However, it is hard to develop and maintain it, as this requires time, money and effort. A friend of ten years is not just a friend to Chinese people; he or she is more like a family member (Tsang, 1998). However, although *ganqing* is an indicator of *guanxi*, it cannot be regarded as the sole element. This is because that *guanxi* is much wider than *ganqing*; *guanxi* includes not only emotional understanding but also other attributes such as obligation and the exchange of favours (Jacobs, 1979; Yang 1994; Luo 1997; Chen and Chen 2004; Yen *et al.* 2011).

Xinren:

The Chinese word *xinren* (信任) means "to believe in", "to trust" or "to rely on" as a verb. As a noun, it means "trust", "trustworthiness" or "credibility". *Xinren* is defined here as to trust or trustworthiness.

Mayer *et al.* (1995) define trust as "the willingness of a party to be vulnerable to the actions of another party based on the expectation that the other will perform a particular action important to the trustor, irrespective of the ability to monitor and control that other party" (p.712). Howorth and Moro (2006) consider this to be one of the best

definitions of trust in that it covers its different aspects and it is relevant to the firm-bank relationship. This definition can also be regarded as the definition of *xinren* which is relevant to the SME-bank *guanxi* here. For example, there exists an information asymmetry problem between banks and enterprises generally: enterprises may provide false information (such as overstated annual returns) to apply for more loans, meaning that banks may face huge risks in the future by granting them these loans. However, if *xinren* exists between banks and enterprises, this means they will trust each other (the enterprise provides true information and the bank will willingly provide loans), then the information asymmetry problem may no longer exist.

Tsang (1998) considers that trust and credibility are two of the most important elements of *guanxi* in addition to *ganqing*; without these, a successful *guanxi* cannot be established. Chen and Chen (2004) think that trust is the foundation of one's *guanxi* network and that "the higher the level of trust between two individuals, the better the *guanxi* quality will be" (p.313). This means *xinren* can help to develop observable measurements of the strength of *guanxi. Xinren* plays a significant role in Chinese business *guanxi*, as it can help to smooth transactions and reduce risks in an environment where business standards and laws are not fully exercised (Yen *et al.,* 2011; Kaynak *et al.,* 2013).

2.2.2 Features (or traits) of *guanxi*

Luo (1997 and 2007a) provided a comprehensive conclusion of *guanxi* features (or principles as he termed them), concluding that *guanxi* is transferable, reciprocal, utilitarian, intangible, contextual, long-term and personal. The intangible feature means *guanxi* is invisible and it is maintained by an unwritten commitment, which requires that people involved in the *guanxi* relationship should always exchange favours with each other. The personal feature means *guanxi* is built upon and operated at individual level; it is people who own *guanxi* and not any organisation. The long-term feature means *guanxi* is developed and maintained through a long process which requires continuous interactions. In addition, *guanxi* is also considered as a capital that could be stocked for a long time (Luo, 2007a; Dunning and Kim, 2007). According to Luo (2005), *renqing* as an element of *guanxi* could be stored and returned even after thirty years. On

the contrary, in Western society, social transactions as a way of favour exchange are practised as isolated events and for an immediate return. However, *renqing* exchange under *guanxi* could be life-long or even be passed to next generation, only if they can maintain it well (Luo, 2007a; Huang *et al.,* 2013). The contextual feature means the cultivation of *guanxi* is a contextual process, and this process could be both positive and negative. For example, normal *renqing* exchange in the form of small gift giving or favor exchange is a tradition in China, but it could turn into a bribe with instrumental purpose (Luo, 2007a). Hence, it is difficult to implement *guanxi* behaviors properly sometimes. According to Su and Littlefield (2001), the former type is defined as oriented towards favor-seeking and is rooted in Chinese culture, and the latter as oriented towards rent-seeking and involves institutions. Zhang and Zhang (2006) consider the former is beneficial for society while the latter is the cause of unethical behaviours such as corruption. All these features are common features of *guanxi*, but this research is focuses mainly on the discussion of the following four features:

The reciprocal feature

Hwang (1987) defined reciprocity under *guanxi* concept as a social obligation and norm in China. People adhere to the "etiquette requires reciprocity" principle (from Confucian philosophy) by following the rules of "if one gives you a peach, you should requite his favor with a plum" and "if you have received a drop of beneficence from other people, you should return to them a fountain of beneficence" (Hwang, 1987: 954, 957). This means that people who receive favours or help from others should repay it as much as they can and whenever the need arises (Wang, 2007; Yum, 1988). People who do not follow this norm will be considered as untrustworthy and which is socially unacceptable in China (Luo, 1997 and 2007a; Yau *et al.,* 2000), and this behaviour might destroy their *guanxi* (Zhang and Zhang, 2006). Therefore, it is a moral obligation to reciprocate favours in China and people who disobey it will lose reputation and face in Chinese society (Yau *et al.,* 2000).

Moreover, many researchers focus on the differences in reciprocity implemented in Western and Chinese contexts. The reciprocal favour exchange in Western networks requires a roughly equal value of reciprocation exchange (Wang, 2007; Lin, 2011), and

which is normally made in the short-term (Huang *et al.,* 2013; Yum, 1988), meaning the reciprocal relationship ends immediately after the exchange is concluded. However, reciprocal *renqing* exchange under Chinese context might not be so balanced between costs and returns; for example, it is easy to repay a cash debt from an acquaintance, but it is hard to repay the *renqing* behind it (Wang, 2007). This means that in order to appreciate the lender's kindness in lending the money, the borrower should repay more returns for this *renqing*. In this example, if the borrower repays this *renqing* from other aspects rather than just interest, he will be considered a "gentleman", since Chinese people consider this generous repayment to be courteous and it could prolong people's *guanxi* (Yau *et al.,* 2000: 18). The result would be endless *renqing* exchanges if both parties continue follow this rule; reciprocal *renqing* exchange under Chinese context is not time bound but occurs over the long-term (Wang, 2007; Huang *et al.,* 2013; Yum, 1988). In addition, *renqing* exchange is not pursued for equal benefits or returns from the costs paid, but for complementary benefits, which means Chinese that *renqing* exchange places more emphasis on quality than on quantity (Lin 2011; Hwang, 1987), and at the right time, when needed (Yau *et al.,* 2000).

The transferable feature

Many researchers provide a similar example to explain the transferable feature of *guanxi*: if person B has *guanxi* with both A and C, but A and C do not have *guanxi* with each other, then B could transfer his *guanxi* with A to C by introducing A to C, so that A finally has *guanxi* with C. The success of this transferability depends on the quality of B's *guanxi* with A and C (Dunning and Kim, 2007; Park and Luo, 2001; Luo, 2007a). Thus, *guanxi* could be transferred to a given third party through a referral (Huang *et al.,* 2013). Luo (2007a) considers it is this transferable feature that differentiates *guanxi* from friendship, since friendship is not transferable.

Fan (2002) considers *guanxi* to be a personal possession rather than an organisational one, and so it can only be transferred between individuals. Taking an example from the research to explain this, a LM has *guanxi* with many SME customers, and when he leaves the old bank, he could take these *guanxi* with him and benefit the new bank. It appears that *guanxi* is transferred between two organisations here, but this nominal

transfer is still based on individual level *guanxi*. This is what Fan (2000) means in stating that *guanxi* transferability can only be done under individual level.

The utilitarian feature

Su and Littlefield (2001) consider that the utilitarian feature concerns personal losses and gains, and *guanxi* with this feature is for an instrumental purpose, so that *guanxi* is always related to rent-seeking and could lead to corruption and bribery. Huang *et al.* (2013) consider *guanxi* to be deliberately driven by personal interest. Zhang and Zhang (2006) have a similar opinion, and consider that people's economic considerations make *guanxi* utilitarian, and that one great incentive of the current use of *guanxi* instrumentally is for people to obtain money or other material goods from *guanxi* transactions. Luo (2007a) considers that a stable *guanxi* relation is built upon continuous interest or exchanges of favours, rather than sentiment; otherwise, it is fragile. Organisations could also gain profits from their employees by using personal level interest exchanges, which makes *guanxi* utilitarian (Luo, 2007a). Therefore, self-interest is one great motivation of utilitarian *guanxi*.

The empathy feature

Wang (2007) considers that the empathy feature involves understanding, consideration and forgiveness of other people; that is, the ability to see other people's perspectives. An empathic person people can understand others' feelings and emotions, and is always ready to fulfil others' needs. Hwang (1987) considers that empathy is guided by the Confucian social norms "Do unto others as you wish done unto you" (p.954). In terms of business, Yau *et al.,* (2000) define empathy as the ability to understand a business partner's goals and desires.

More importantly, the empathy feature has led to a different way of thinking among Chinese people compared to 'western' people. In Yum's (1988) view, this is reflected in differences in communication pattern. The Western communication pattern is sender-centered and is straight, which means the information is delivered from the sender to the receiver straightforwardly. In contrast, the Chinese communication style is receiver-centered (Yum, 1988). As Yau *et al.,* (2000) state, "the Chinese are unlikely to

communicate their preferences and opinions openly, so as to avoid offending or for fear of being rejected by others" (p. 19). So, when someone is unhappy, a 'western' person might just express it straightforwardly, while a Chinese person might not show this unhappiness directly to another person. In this case, the receiver has to distinguish the information he has obtained, e.g. to identify whether the sender is unhappy or not through his facial expression or mood. Hence, the Chinese pattern is receiver-centered. In addition, the Chinese culture is a high-context culture, which means people will leave many things unsaid during their communications (Hall, 1976). Thus, in business activities in China, what is said might be less important than what is not said, and people are expected to anticipate their counterparts' needs without being told or asked; they have to guess others' true feelings and meanings (Wang, 2007; Yau *et al.,* 2000). The receiver-centered communication style is apparent in the research data of this thesis, and some specific examples from interviews will be presented in the empirical chapters and discussed in Chapter 8 later. It was also found in this research that the empathetic way of thinking is present throughout the whole SME lending process as well, and has a great impact on the behaviour of those involved. This is termed 'indirectness' in this research and will be discussed in greater detail in the discussion chapter (Chapter 8).

The above sections explain the concept and structure of *guanxi*, the former to help the reader understand Chinese context *guanxi* better, while the latter is very important since it forms the basis of analysing *guanxi* in SME lending, which also represents a contribution to the literature. The following section presents the theoretical framework of this thesis, which introduces the theories that are advocated in the study.

2.3 Theoretical framework

2.3.1 Institution and Institution Change Theory

According to the institution theory of North (1990, 1991), institutions are the constraints designed by humans to structure their political, economic or social interactions. The function and purpose of institutions are to reduce uncertainty in human exchanges (i.e. borrowing money or doing business), create order in human society and ensure the proper functioning of the society. Therefore, institutions are guidelines for human interactions and consist of formal rules and informal constraints (North, 1990).

The formal institutions or rules include "political (and judicial) rules, economic rules, and contracts", with political rules often leading to economic rules (North, 1990; 47-48). Formal rules such as official laws and property rights are created to constrain human behaviors through the legal framework (Dunning and Kim, 2007), and to facilitate political or economic exchanges (North, 1990). Since formal rules are not the main subject of this research, they are explained very briefly here. Informal rules or constraints include culture norms, traditions, customs, codes of conduct and so on, which are devised to guide individuals to behave properly with 'generalized morality' in terms of social norms or values (North, 1990, 1991, 2005; Dunning and Kim, 2007; Granovetter, 1985: 489). Arrow defines informal institutions as 'implicit arrangements' or invisible institutions that follow the principles of ethics and morality (Arrow, 1974; 26). Informal rules are normally moral commitments followed by people themselves, while formal rules such as laws are external obligations imposed by the government (Jacobs *et al.,* 1995). North (1990) contends that institutions could establish a stable structure to reduce uncertainty in human relations, but that they are also changing and evolving at the same time. Formal institutions could change overnight due to political or judicial decisions, while informal rules are "embodied in customs, traditions, and codes of conduct are much more impervious to deliberate policies", and change incrementally (North, 1990: 6). North (1990) defines these as cultural constraints and emphasises their importance in understanding the path of historical change of institutions.

North (1990) considers that although formal institutions play an extremely important role in ruling normal life and the economy, particularly in Western societies, they only account for a small part of the constraints. In contrast, informal rules are more universal than formal rules in social life. Since it is not compulsory for people to follow these informal institutions, the enforcement of informal rules might not be as strict as that of formal rules. However, Dunning and Kim (2007) suggest that informal rules could sometimes have deeper impacts on human behaviour than formal rules, particularly in places where formal legal systems are not well established, such as China. The implementation of formal institutions in China is not as well-developed as it is in Western countries, so informal rules are commonly used in China as a supplementary of formal rules. Jacobs *et al.* (1995) consider the existence of this phenomenon to be due to the differences in state systems and ideology between China and Western countries since ancient times. The serf system based on contractual relations and the power of the Church led to the establishment of formal laws such as civil law in ancient Europe. However, Imperial China relied on the small-scale peasant economy system and there were no contractual relations; there were only criminal law and feudal decrees in ancient China. Furthermore, the Confucian ideology under the feudal political system also made these formal institutions difficult implemented, and finally formed the most common legal management style in China, 'rule by man' rather than 'rule by law', a structure which developed into a tradition that still has its impacts in China (Jacobs *et al.,* 1995: 30; also see Chapter 3, section 3.2, 3.3). The choice between formal and informal institutions (rules) is also about the choice between "rule by law" and "rule by man" in the Chinese context.

In modern China, the market economic reform started in 1978 is still imperfect, and the legal system remained inadequate[4] during this transformation period (Zhang and Zhang, 2006, also see Chapters 3 and 8). So with this background, in Chinese society, apart from written laws, regulations and systems, there are also unwritten rules established by usage. Such unwritten or informal rules have no legal effect, nor are they easy to explain, and may be even inconsistent with legal or formal systems. They are codes of

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[4] For example, there was no Contract Law in China until 1999.

conduct established by usage and recognised in human life, and non-institutionalised rules with historical origins as an invisible power that dominates human activities in the society (Fei, 1992; Luo, 1997, 2007a; Wu, 2001). The *"Qian guize" (潜规则)*, translated as 'latent rule' or 'informal rule' hereafter, first appeared in a book named *Latent Rules: The Real Game in Chinese History* published by Professor Wu in 2001 (in Chinese). Contrary to meta-rules and well-defined formal rules, latent rules refer to the widely-accepted invisible and undefined informal rules which can exert a practical effect in work and must be abided by (Wu, 2001). They fall beneath formal rules and work as complements to them (Hsiung, 2013). Wu (2001) considers *guanxi* to have been the most important latent rule in China since ancient times. Based on Landa's (1981) research, Hsiung (2013: 27) defines *guanxi* as "a club-like institutional arrangement developed in the Chinese society to deal with problems of contract-uncertainty. Luo *et al.* (2012) suggest that interpersonal *guanxi* could be used as a substitute for some formal institutions and to facilitate economic activities such as business operations and resource acquirement. Thus, *guanxi,* as a latent rule, could compensate for defects in formal institutions and is an alternative to formal rules (Dunning and Kim, 2007). Thus, Zhang and Zhang (2006) consider that *guanxi* could function more effectively than a formal institutional framework and maintain a stable social and economic order in China when the formal rules could not exercise their functions.

2.3.2 The Embeddedness Theory

Embeddedness is a very important concept in both economic sociology and economics. It was first proposed by Karl Polanyi in his book '*The Political and Economic Origins of Our Time'* in 1944. Polanyi (2001 [1944]) considers the rise of institutions like market economy and free trade to have completely changed human society. Before the nineteenth century, human economic activities were embedded in society and institutions, and the market was not dominant. In this case, reciprocity, redistribution and house-holding, which were under the social or cultural structure, were the principles used to ensure the proper functioning of the economic system and to guide economic behaviour. However after the emergence of market economy in the nineteenth century, the economic system was controlled by the market, and society became only an adjunct

of the market. Thus, "Instead of economy being embedded in social relations, social relations are embedded in the economic system" (Polanyi, 2001 [1944]: 60). Polanyi's concept of embeddedness had a significant influence on both the economic sociology and economics fields; he explained the embedded relationship between economy and social relations macroscopically and theoretically. However, he did not have a specific explanation about how this embeddedness works in society.

Another new economic sociologist, Mark Granovetter, extended this concept into a new theory. The purpose of Granovetter's proposal of 'embeddedness' in 1985 was to debate and criticise the most famous assumption in economics: the hypothesis of rational economic man or the rational choice theory, which assumes that people are completely rational and self-interested in their behaviour, and are rarely affected by the social relations around them (Granovetter, 1985; Mankiw, 2006). According to Granovetter (1985), from classical economics to neoclassical economics, economists such as Adam Smith and Hirschman, all maintained the utilitarian tradition and believed that human action was socially atomised, that rational atomised individuals make their own decisions to pursue maximum self-interest, and economic behaviour such as production, distribution and consumption were independent of social structure and relations. He considers this perceive is under-socialised. On the contrary, sociologists considered that social norms and values would be internalised into human behaviour naturally, through the process of socialization, with the result that the actors are "overwhelmingly sensitive to the opinion of others" and obey these norms and values without consciousness, which is over-socialisation (Granovetter, 1985: 483; Wrong, 1961). Hence, the under-socialised concept in neo-classical economics emphasises individuals' free will and rational interest pursuit, while the over-socialised concept in sociology places too much emphasis on the effects of informal institutions such as social norms, values, and customs. In conclusion, Granovetter (1985) considers both of these two concepts to be too extreme; actors are neither completely independent of social context such as customs, culture and politics, nor do they adhere to the social system like slaves without self-consciousness, but their behaviours are both autonomous and also embedded in and restricted by the system of their social relations. This means that although the actors have their own preferences in making economic decisions, they are still partially

affected by the society around them. This is the central concept of embeddedness proposed by Mark Granovetter, and which is based on the social network theory and network analysis (Granovetter, 1985; Luo, 2007b).

Since Mark Granovetter's embeddedness theory was not presented at once but released gradually over several works, the conclusion of embeddedness theory here is largely based on his main works (Granovetter, 1973, 1983, 1985, 1988, 1990, 2005) and other scholars who developed this theory afterwards. Granovetter divides embeddedness into 'structural embeddedness' and 'relational embeddedness' (Granovetter, 1990: 98-100). The former focuses on the integrality of the network and the functions of the actors in the network. Following Granovetter's work, Nahapiet and Ghoshal (1998) redefine the concept of structural embeddedness as "the impersonal configuration of linkages between people or units" (Nahapiet and Ghoshal, 1998: 244). Chan (2009) defines it as "networks of interpersonal relations" (Chan, 2009: 713). The latter, relational embeddedness, describes the mutual relationship between actors, namely, strong, weak and absent ties (Granovetter, 1973 and 1990), or "interpersonal relationships among individual economic actors" (Chan, 2009: 713). Granovetter (1973) suggests that the strength of ties in relational embeddedness can be measured through "the amount of time", "the emotional intensity", "the intimacy (mutual confiding)", and "the reciprocal services which characterize the tie" (Granovetter, 1973: 1361). Based on these measurements, Moran (2005) considers the most important factors in measuring relational embeddedness to be "interpersonal trust and trustworthiness, overlapping identities, and feelings of closeness or interpersonal solidarity" (Moran, 2005: 1132). Thus, the strength of interpersonal relations or ties is positively related to the amount of time of the interactions, with a longer interaction meaning that the closeness between the participants is higher and they are more willing to reciprocate.

In order to prove the validity of his embeddedness view, Granovetter uses this embeddedness theory to analyse the "trust and malfeasance" problem in economic life (Granovetter, 1985: 487). Although Granovetter does not explicitly mention the words 'strong tie', nor does he explain it in his paper *Economic action and social structure: The problem of embeddedness* in 1985, I consider he is actually talking about how strong

ties create trust and then reduce the malfeasance problem. As this paper actually focuses on close relationships, he was talking about how these long-term, continuing and close friendships help the actors build trust and emotional acceptance between each other, and it is only a strong tie that has this ability to create deep trust. This means that embeddedness theory emphasises that a strong tie is considered to produce trust among the participants and thus discourage malfeasance.

In order to solve the malfeasance problem, some neo-institutional economists suggest that the formal institutions like laws or regulations have a function in reducing it. Granovetter (1985) considers it to be an under-socialised way, since formal institutions are designed to replace trust but not to produce it, and such substitution would give greater motivation to rational individuals to bypass or evade the institutions. Thus, economic life would deteriorate, and so it is not a good solution. At the same time, Granovetter (1985) considers another solution; the "generalized morality", used by other economists such as Kenneth Arrow is not reasonable either and is over-socialised (Granovetter, 1985: 489). Arrow (1974) considers that the society itself will generate some "implicit arrangements", ethics and morality, to regulate people in the society and build trust between them (Arrow, 1974: 26). Arrow's opinion is justified to some extent, since the emergence of Confucianism in Chinese society is a good example supporting his view (which will be discussed later in the philosophical background section of the methodology chapter, Chapter 3). However, it is undeniable that ethics and morality from Confucianism did have some impact on Chinese people, but still within limits, since China remains a low-trust country (Wang, 2007). Therefore, general ethics and morality could not create generalised trust and solve the malfeasance problem in Chinese society. Granovetter (1985) considers trust to be generated through the frequent interactions between people in their social relations. It is the understanding of someone by other people, that is, his reputation in society that makes him trustworthy, and it is even better if this understanding is perceived by the observer himself through his own interaction with that person, because it is more accurate in this way. Granovetter (1985) considers this kind of continuing interaction and the information obtained from it to be valuable and reliable since: (1) if the actor wants to maintain this continuing relation, he would have the economic motivation to show his trustworthiness to the counter-party,

as otherwise, future cooperation would be affected; (2) this "continuing economic relation" could bring confidence and satisfaction in their social relations, which makes the participants expect trust behaviours and not opportunism (Granovetter, 1985: 490). Thus, this kind of long-term and strong relation could change the actors' motivation from the pursuit of pure self-interest into trust and reciprocity in their relations. So, according to Granovetter (1973 and 1985), the embeddedness theory emphasises that it is the social relations, networks and structures rather than just formal institutions or generalised morality that generate trust and that trust is therefore embedded in strong interpersonal ties or network and could reduce malfeasance in economic life (Granovetter 1985: 491). In contrast to the benefits that strong ties could bring, such as trust and trustworthy behaviours, Granovetter (1985) suggests that this strong social relation and trust may also lead to greater malfeasance at the same time. These long-term personal relations are sometimes used for "concealed purposes", and "the more complete the trust, the greater the potential gain from malfeasance" (Granovetter, 1985: 491). Which implies strong tie could also lead to collective fraud, malfeasance in the form of an entire network. Granovetter (1985) considers network malfeasance to be more destructive than malfeasance at the interpersonal level.

Hsiung (2013) views Granovetter's research as similar to that of Landa (1981), the difference being that Granovetter does not consider humans to be completely rational, nor does he use the transaction cost approach. Both Landa (1981) and Granovetter (1985) consider the relations between organisations to be embodied in the trust of interpersonal relations, for example, the relations between the top executives of organisations. At the same time, through the research on Chinese middlemen's behaviour in business, Landa (1981) finds that they will form special exchange groups or networks (or *guanxi* circles in the Chinese context) which are based on personal relations to reduce contract uncertainty, and that while group members do not necessarily have to pay cash during their transactions, non-members are required to do so. Landa (1981) considers these networks as an alternative to formal institutions such as contract law when law enforcement is weak. It is clear that there exists deep trust in those networks. So Landa's research findings offer direct support for Granovetter's embeddedness theory, that social relations and networks could produce trust and reduce malfeasance in economic

life, particularly in circumstances where legal and formal institutions are imperfect.

In contrast to the importance of strong ties in economic life, Granovetter (1973 and 1983) points out that weak ties have more advantages in terms of obtaining and transferring information. This view was not commonly accepted initially when Granovetter first proposed it, but was ultimately shown to be accurate (Luo, 2007b). Granovetter (1973) argues that the possibility of an overlap in friendships and circles is higher when the participants' ties are stronger. The basic hypothesis proposed by Granovetter, is that, if A has strong ties with B and C respectively, then the possibility of B and C knowing each other is higher when A has stronger ties with both B and C. Otherwise, B and C are less likely to know each other if A-B, A-C ties are weaker. (Granovetter, 1973: 1362). However, Burt (2009) points out that the overlapping of information could also be facilitated by stronger ties. When A passes a message to both B and C, and then B passes this message to C, but C already knows it due to his strong tie with A; therefore, the information channel between B and C is 'redundant' since they lead to the same resource, A (Burt, 2009: 18, 19). Hence, in this case, for example, if A and C do not have a strong tie, which means A would not transfer this message to C, then the information would not overlap. Granovetter (1973 and 1983) believes that it is because a weak tie has lower possibility of overlapping in friendship circles than a strong tie, so it could connect more individuals or relations or networks, meaning that there is a greater higher possibility of obtaining more information and resources. Furthermore, Granovetter (1973) uses the concept of a 'bridge' to explain a unique weak tie which is the sole conduit for the transfer of information between two individuals or social networks. Weak ties are not necessarily 'bridges', but all 'bridges' must be weak ties (Granovetter, 1973: 1364). Luo (2007b) defines a bridge as the unique path to transferring information from one group to another. It is easy to transfer information between group members since they normally have strong ties within the same group, but it is difficult to transfer information between two different groups, so the weak tie between two members from each group form a unique information transfer channel. He considers this channel, namely the bridge, to be valuable in spreading information, and is the key to ensuring that information could be transferred between these two groups. Moreover, Luo (2007b) agrees with Granovetter's view that this bridge has to be a weak

tie, since, if it is a strong tie between the two members, then they will introduce their group members to each other, and these members will eventually form new ties, with the result that this path is no longer unique and loses its value in transferring unique information. Therefore, as can be seen from the definition of a bridge here, a bridge is a specific type of weak tie that has the function of transferring important information, which was not able to flow between the groups or networks without it. So a bridge could connect different types of groups or networks which did not have previous connections, and share information and resources between them. Through the analysis of labour market study about job changers who live in a Boston suburb and use contacts to find new jobs, Granovetter (1973, 1988) shows the importance of weak ties in searching for jobs. From the empirical research findings, he finds that it is easier for the job searchers to obtain valuable job information from those people whom they do not contact regularly, rather than from those with whom they are in frequent contact and have strong ties with. This implies that weak tie people are more helpful in providing useful information. Hence, it was demonstrated that weak ties have advantages over strong ties in terms of securing opportunities, information and resources, and people with more weak ties have more information resources and can therefore obtain better jobs.

After Granovetter, many other scholars also helped to develop the embeddedness theory. For example, after studying some recent Mexican immigrants in the American labor market, Amado (2006) found that personal relations based on the same cultural background is very important for these new immigrants in finding a job, since many of them cannot speak English, so they have to rely on these co-ethnic ties, showing the importance of the same culture background embeddedness. Apart from cultural embeddedness, Zukin and DiMaggio (1990) also suggest that researchers to pay attention to 'cognitive embeddedness' and 'political embeddedness' (Zukin and DiMaggio 1990: 15, 20). Uzzi (1999) used the embeddedness approach to research the relationship between bank and borrower, and found that social relations and networks helped firms in seeking financing and could reduce credit costs. Chan (2009) researched the role of *guanxi* in life insurance transactions in China, finding these transactions to be remarkably socially and culturally embedded in three types of *guanxi* ties. Similarly to previous literature, this thesis also researches the culture embeddedness of *guanxi* in

China actually, which helps to enhance the embeddedness theory. In this thesis, I will use the embeddedness theory to identify the role of the Chinese *guanxi* concept as a tie of social relations, and also a culture tradition in the economic behaviour of SME lending, and try to fill in some gaps (i.e. the cultural aspect) of the embeddedness theory.

2.3.3 Social network and social capital

Since Mark Granovetter's embeddedness theory is based on the network analysis and carries the social network theory forward (Granovetter, 1973 and 1983; Emirbayer and Goodwin, 1994; Luo, 2007b), it is also important to give a brief introduction to a further two very important concepts in New Economic Sociology: the social network and social capital. Different researchers have different definitions of social network. Emirbayer and Goodwin (1994) define it as the set of social relations that connects group members. Kilduff and Tsai (2003) consider a social network to be the collection of both the actors in the network and also their relationships. Greve and Salaff (2003) view a social network as a set of connections between specific individuals such as entrepreneurs, and that it can be used to obtain information and resources from others who are also in the network. The concept of the *guanxi* circle mentioned in this research is also a form of network in fact, since the members inside a circle are normally people who know each other or have the same industrial background. The *guanxi* circle will be discussed in further detail in Chapters 6 and 8.

Social capital is considered to be the resources which are rooted in social relations or relationships as a resource which could influence social and economic actions (Coleman, 2000; Baker, 1990; Bourdieu, 1986; Burt, 2009; Nahapiet and Ghoshal, 1998). Lin *et al.* (1978) define these resources as "the wealth, status, power as well as social ties of those persons who are directly or indirectly linked to the individual" (Lin *et al.,* 1978; Lin *et al.,* 1981: 392). Based on these, Lin defines social capital as the "investment in social relations with expected returns" (Lin, 1999: 30). He also emphasises that the network should also be paid attention to in social capital research, since the investments are made into the network and returns (i.e. wealth, reputation, resources) are also obtain back from it. This explanation actually emphasises the importance of structural embeddedness in economic transactions or exchanges. Coleman (2000) and Portes

(1998) think that social capital could promote the cooperation between actors and smooth economic and political actions. *Guanxi* which expresses social relations in the Chinese context could also be considered as a form of social capital, since *renqing* as part of *guanxi* could bring advantages in terms of interpersonal exchanges of favour, the *renqing* given to others are social investments and a return could be expected from it (Luo, 1997; Yau *et al.,* 2000). As a kind of social capital, *guanxi* could be used to smooth economic transactions and reduce transaction costs (Hsiung, 2013; Lovett *et al.,* 1999). Coase (1937 and 2012) divides transaction cost into three types: search cost, negotiation cost and enforcement cost. Landa (1981) find that *guanxi* could reduce all these three kinds of costs in business transactions when formal institutions are weak. SME lending is also a kind of transaction, so it will be discussed in this thesis (see Chapter 8) whether *guanxi* could reduce these costs or not.

2.4 Summary and research question

According to the theoretical framework above, the embeddedness theory will be applied to analyse *guanxi* as a social relation, network and capital. The institution and institution change theory will be advocated to analyse *guanxi* as an informal rule. This research wants to combine new institutional economics and new economic sociology to some extent and extends both research areas. The embeddedness theory has had a huge impact on both economics and sociology, it remedies the imperfections of under-socialisation in economics and the over-socialisation in sociology. It considers that humans are not completely rational but are also affected by the social relations around them, so that the economic behaviours of humans are also embedded in the society but not dependent on it. However, the embeddedness theory also has its limitations, for example, Granovetter did not provide very specific explanations of the definition and functions of the strong tie in embeddedness theory, so this theoretical framework defines the continuing and close friendships mentioned by Granovetter (1985) as strong ties. Two basic functions of relational embeddedness (or theorems of the embeddedness theory) are concluded here: (1) a strong tie could be used to generate trust and reduce malfeasance in economic life; (2) a weak tie has more advantages in terms of obtaining and transferring information between two different networks or groups (Granovetter, 1973, 1983 and

1985). In addition, although Granovetter mentioned that the 'culture influence' would gradually affect human behaviour (Granovetter, 1985: 486), he did not explain the effect specifically. Moreover, as he himself mentions in the foreword to a Chinese book which contains five of his main papers (translated and edited by his student Luo, 2007b), he did not pay great attention to the importance of culture in embeddedness. North (1990) also mentions the influence of culture in social actions. In this research, I will conduct an in-depth investigation into the cultural embeddedness of *guanxi* (as a culture tradition or phenomenon) in the Chinese context, and try to improve the embeddedness theory by analysing the functions of *guanxi* from the aspects of it as both a strong tie and weak tie.

Furthermore, similar to Granovetter's (1985) use of embeddedness to research the trust and malfeasance problem in economic behaviours, this thesis also researches the trust and malfeasance problem of SME lending in China. As discussed in Chapter 1, the phenomenon of fraudulent financial statements is common in China; false financial statements are widely used by enterprises, particularly SMEs, to apply for loans. In this light, the main research question was proposed in Chapter 1:

How do manufacturing SMEs obtain loans in China?

However, in order to answer this broad question accurately, another insight is first required:

(1) What is the current accounting information environment in China, and what are the causes and incentives of this environment?

This question seeks to discover the real situation of financial statement problems in China and tries to find out why it happens. The answers to this question could provide some initial insights into the negative phenomena mentioned by previous literatures, and offer some implications for theories of financial reporting. If the empirical findings show that the reality corresponds to previous literatures as mentioned before, other questions arise:

(2) How do Chinese financial institutions such as banks conduct evaluations of Chinese SMEs in order to make lending decisions, and what factors will affect the lending decision-making?

The second question seeks to explain, if we are then to accept that accounting information such as financial statements is not very trustworthy or reliable, then how do Chinese financial institutions investigate SMEs and conduct loan approval procedures, and what factors other than financial information could influence lending, which is completely different from recognised Western banking practices. The above two questions are important since they could provide some background information for this research, and are also the starting point of and motivation for this study.

Both North (1990) and Granovetter (1985) consider that actors cannot be completely rational in economic life. So in order to promote the development of social science, they believe these rational assumptions (i.e. the rational choice theory) need to be modified. In addition, they pay great attention to human interactions (as North says) or social relations (as Granovetter says) in economic life, which in fact have the same implications. *Guanxi* is a social relation which represents human interactions in the Chinese context, so another very important research objective of this thesis is to answer the question:

(3) What role does *guanxi* play in SME lending exactly? How and why could it affect lending from a cultural and institutional perspective?

Or, to be more specific, what are the functions of *guanxi* in the process of Chinese SME lending? Does it help to improve credit access for Chinese SMEs? Could it reduce the cost of credit or requirements of financial institutions for SMEs? Does it have a positive or negative impact on the lending process? Could it reduce malfeasance problems (i.e.

fraudulent financial statement) or exacerbate it, or both[5]? *Guanxi*, as a social capital and informal rule in China, is embedded deeply in the Chinese culture and society. Hence, this thesis seeks to explore in depth how SME lending as an economic behavior is embedded in *guanxi*, but not independent of it. In conclusion, based on embeddedness theory, institution and institution change theory, the *guanxi* structure is analysed from a cultural and institutional perspective in SME lending in this research.

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[5] Note: the concept of ties discussed by Granovetter in his research is assumed to be 'positive' and 'symmetric' (Granovetter, 1973: 1361), but this research also seeks to discuss the negative and asymmetric aspects of *guanxi* ties.

Chapter Three: Methodology

3.1 Introduction

Chapter 1 provides background information on SME financing and the Chinese financial system, as well as introducing the motivation, which is the starting point of this thesis. Chapter 2 proposed the *guanxi* structure and theoretical framework in the literature, which will be used to analyse the role of *guanxi* in SME lending in China. At the end of Chapter 1, several research questions are outlined. Hence, in order to achieve the research purpose and answer these questions, this chapter mainly explains the philosophies and methods that are used in the design and analysis of this research. Starting by introducing the philosophical background, this chapter presents the cultural roots and historical institution changes of informal rules and *guanxi* in China. These are important since they are the foundations of the application of the embeddedness theory and institution change theory to analyse *guanxi* in the Chinese context. Without these, it is not possible to understand *guanxi* culturally and institutionally. The data collection and analysis method of this research are then introduced, followed by ethical considerations and reflections.

3.2 Philosophical background

3.2.1 Epistemology and ontology

Epistemology concerns the nature of knowledge, which studies the problem of what and how knowledge could be presented in an acceptable way (Bryman, 2016; Holden and Lynch, 2004). Positivism is the counterpart of natural science research, which applies natural science research methods and logic ('principles, procedures and ethos') to social science, and explores how society structure shapes individual's behaviour and social actions (Bryman, 2016: 24; McNeill and Chapman, 2005). Positivism is 'objective' and positivists believe that social structure of society is more important than individual behaviour in understanding social life (McNeill and Chapman, 2005: 15, 16). However, interpretivism is more subjective and interpretivists emphasise that all social actions are intentional, and these 'actions are the result of people's interpretations of the situation

that they are in', but not governed by objective laws (McNeill and Chapman, 2005: 19). So in order to understand social life, interpretivists argue that it is important to examine people and their social interactions first. As a qualitative social science research, this research presents primary data collected by the researcher to analyze the lending action between LMs and SME managers, and then explore the role of *guanxi* as type of social interaction in this process. This research does not deny the importance of social structure in understanding social actions, but focuses more on the analysis of people involved and their relations. Therefore, it is indicated that interpretivism is mainly adopted in this research.

Ontology concerns the nature of social reality, which focus on the question that whether social reality is dependent or independent of the individuals in the society, which means whether reality derives from the perceptions and interactions of social actors, or is formed objectively without the influence of people (Bryman, 2016; Gruber, 1995). Objectivism implies that social phenomena and meanings are beyond individuals' reach or influence since they are external existing reality, while constructionism asserts they are accomplished and produced by the actors involved and through their continuous interactions. Constructivists consider that social reality is not something external which constrains us, but it is we as social actors who constitute it through our social interactions (Potter, 1996; Bryman, 2016). The central concept of embeddedness theory prosed by Mark Granovetter (see Chapter 2) emphasises that economic life or behaviour (a kind of social phenomenon) is embedded in social relations (interactions). Granovetter (1985) considers that people have free will, but they are not socially atomised. When they are making economic decisions, Granovetter considers they are still affected by the social structure, the people or the society around them. Since they are embedded in social networks, they have to interact with other people in society (Granovetter, 1985). As Mark Granovetter used dialectical thinking to criticise over-socialisation and under-socialisation, this research considers that social actors and their interactions are important since they could influence social reality. However, at the same time, this research holds the view that social reality or phenomena could also constrain social actors and their interactions. In SME lending area, LMs and SME managers conduct credit transactions. When they make decisions, the findings show

that the lending decision is affected by many factors; for example, formal/informal institutions, culture (i.e. social norms, values and customs), as well as social relations such as *guanxi*. The empirical findings also show that it is still people who make these decisions. Although they will pursue self-interest, they will also engage in some reciprocal behaviour, since they have to interact with other people and are constrained by the external existing society or social structure around them. Therefore, SME lending, this economic behavior, is embedded in *guanxi* in China, which means *guanxi* could affect lending.

3.2.2 Confucianism and *guanxi*

It was shown in the literature review chapter (Chapter 2) that *guanxi* is no longer just a cultural tradition, but has many different meanings and connotations in modern times. Despite these changes, the origin of *guanxi* can be traced back to the Confucianism, which is an ancient Chinese philosophy. It is a common view that *guanxi* derives from Confucianism, as the core foundations (i.e. reciprocity) of *guanxi* are inherited from many fundamental principles of Confucianism (Gong *et al.,* 2013; Lytras and Pablos, 2009; Huang *et al.,* 2013). Therefore, if we wish to research *guanxi* and the ideology behind it, it is necessary to know its philosophical background, which is Confucianism.

Confucius (551-479 B.C.E) is the most famous philosopher and educator in China, who lived during the Eastern Zhou Dynasty (Lin, 2011). Confucianism was first generated in the late of the Spring and Autumn period[6] (770 B.C.E – 476/403 B.C.E) in ancient China by Confucius, then his students and other Confucian scholars developed it into a complete philosophical system. The influence of Confucianism philosophy on the Chinese people equates with the influence of Ancient Greek philosophy in the West. Confucian ideology is about social values, ethics, orders, rules and the hierarchical structure of people and society in China (Luo, 1997; Lin, 2011). Confucius (1915) believes that social harmony could be achieved only if everyone behaves properly according to his position in the social hierarchical structure. Therefore, the central

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[6] The Spring and Autumn period is an ancient Chinese period in the Zhou Dynasty (1045 BC- 221 BC). Hundreds of schools of philosophical thought and religious ideas such as Confucianism and Taoism emerged in this period. The influence of the Spring and Autumn period in China is like that of the Renaissance period in the West.

concept of Confucianism is to establish a well-structured social order of society, and finally to form an ideal country with harmonious human relations (Lin, 2011; Huang *et al.,* 2013). Confucianism was later proposed to consolidate the governance of the central monarchy. During the Han dynasty (206 B.C.E- 220 C.E) around 134 B.C.E, in order to maintain his governance, the emperor Wu (156-87 B.C.E) firstly abandoned other schools of thoughts and advocated the Confucianism as the primary philosophical system of the country. Since then, every generation of emperors has treated it as the main rule of the country, and every citizen in the country has been supposed to follow Confucian thought; Confucianism became the dominant philosophical system and ideology throughout the whole period of Imperial China and indeed, has remained so to the present day (Jacobs *et al.,* 1995; Hsiung, 2013).

Although Confucius did not mention the word '*guanxi*' in his major works, he might be the first person to conclude individual level *guanxi* in ancient China. King (1991) took an in-depth look at how *guanxi* is conceived in the philosophy of Confucianism. He argued that although *guanxi* as a relatively modern word that was used directly in any of Confucius works, *Wulun* (五伦) and *Wuchang* (五常) are used. Confucius and Mencius (who continued his work later) classified *guanxi* into five basic relationships: emperor and citizen, husband and wife, parents and children, brothers and sisters, and friend and friend, which are also known as *Wulun* (五伦, briefly, *"Wu"* means five and *"lun"* means human relationships) or five cardinal relations (Su and Littlefield 2001; Hsiung, 2013).

The key meaning of *Wulun* is five kinds of basic human relationship. However, the word *"lun"* has more meanings than just human relations. Fei *et al.* (1992) stated that *"lun"* could also mean social order. He thinks that the emperor, husband, parents, senior friend and elder brother enjoy more rights and privileges than their opposites in the five cardinal relations (or *Wulun*). There also exists an order-obey relationship and rank between these superiors and their subordinates (Su and Littlefield, 2001; Hsiung, 2013). For example, the emperor is obviously of a higher rank, which means he could command citizens, and citizens should obey him. Relations between the other pairs also

follow this Confucian doctrine. These five relations may be slightly limited in defining all modern-day human relations, but Chinese people still follow this ideology. To take a recent example, in the teacher and student relation, student should always be humble, respect their teachers and follow them. Hence, Chinese students are unlike Western students in that they always obey their teachers and would not usually offend them. Furthermore, the stronger and more powerful partner in the relationship also has the obligation to help the weaker, and gains a good reputation or other benefit in return (Fei *et al.,* 1992; Lin, 2011). Huang *et al.* (2013) argued that 'power distance' is not only a very important factor of Confucianism but also exists in *guanxi*. This is because the participants involved in a *guanxi* relationship are normally not of the same rank and level, which makes the weaker partner ask for help through favours (Zhang and Zhang, 2006), and which makes *renqing* exchanges occur. In addition, they also defined a third meaning of *"lun"* as the moral principles that the participants follow in their social interactions. Just as different moral principles are applied in different relationships, the occurrence of different types of *guanxi* is also based on the types and natures of the relationships. Therefore, Huang *et al.* (2013) suggest that these three meanings (human relationships, social order and moral principles) of the Confucian term *"lun"* could reflect the nature of *guanxi*, which also means *guanxi* is derived from the Confucianism, or as they have concluded: "Confucianism leads to a strong perception of *guanxi*" (p. 335).

Until 134 B.C.E, some Confucian scholars summarised the Confucianism into *Wuchang* or five constant virtues: *Ren* (仁); *Yi* (义); *Li* (礼); *Zhi* (智); and *Xin* (信) (Gong *et al.,* 2013: 363). The first three constants were proposed by Confucius himself, while *Zhi* (智) was proposed by the famous philosopher Mencius (ca. 372-289 B.C.E), and *Xin* (信) was added by another Confucian, Dong Zhongshu (ca. 179-104 B.C.E). *Ren* (仁) here means the humaneness between people. According to *Lunyu (论语, the Analects[7])*, Confucius defined *Ren* as one should not do something to others that he would not wish done to himself, which means people should have empathy and always think from

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[7] Which book records Confucius and other Confucian scholars' main thoughts and sayings, Gong *et al.* (2013) treat it as 'the bible of Confucianism' (p. 363).

others' point of view. *Yi* (义) means loyalty. In ancient times, it could be the loyalty between emperor and citizens, while in modern times it can be the loyalty between friends or business partners. *Yi* can also be defined as righteousness, which means people should adhere to the moral principles. *Li* (礼) means propriety; people should have proper behaviours and good manners. *Zhi* (智) means wisdom or knowledge, which can be moral knowledge or scientific knowledge. *Xin* (信) means integrity, which indicates that promises should be kept (Confucius, 1915; Angle and Slote, 2013; Gong *et al.,* 2013). The five constant virtues (or *Wuchang*) are actually five behavioural guidelines that people should follow in interacting with others; people are required to regulate themselves according to these guidelines. The ultimate purpose of these guidelines is to achieve a harmonious state of interpersonal relationships in society (Luo, 1997; Huang *et al.,* 2013).

Wulun (the five cardinal relations) and *Wuchang* (the five constant virtues) from Confucianism reflect some of the most important aspects of *guanxi* concept. In general, *Wulun* asks that people know their positions in the society and *Wuchang* requires that people should behave appropriately to their positions. To the present day, the Confucian philosophy is still influencing behaviours such as the business practices of Chinese people, as well as the *guanxi* structure among them (Jacobs *et al.,* 1995; Dunning and Kim, 2007; Zhang and Zhang, 2006). As Yum (1988) states, Confucianism holds that a harmonious society should be built upon the basis of appropriate human relationships. In order to achieve this goal, people should follow Confucian doctrines such as *Ren* (humaneness), "which is understood as a warm human feeling between people and strongly emphasizes reciprocity" (Yum, 1988, p. 374). Another term, *Li* (propriety), in Confucianism, which means people should have proper behaviours and good manners in the society, is also a very important element in maintaining personal *guanxi*. People should behave properly, such as by respecting age and authority in interactions with others (Hong and Engestrom, 2004). Huang *et al.* (2013) consider that the concept of harmony, which is also the main idea of Confucianism, is very important to *guanxi*. A good *guanxi* should also be a harmonious relationship; people should love and respect each other. Thus, social relations in terms of *guanxi* derive from the doctrines of

Confucianism, and as a philosophy of humaneness and reciprocity, Confucianism has left a significant impact on the evolution of interpersonal *guanxi* in China.

3.3 Cultural embeddedness and historical changes

3.3.1 Culture roots of latent (informal) rules and *guanxi*

Guanxi is the most important latent (informal) rule in China (Wu, 2001), and the formation of latent rules depends upon China's traditional economic and political systems. Firstly, it is determined by the small-scale peasant economy system. China has been an agricultural country since ancient times (Fei, 1992), and under the traditional form of small-scale peasant economy, production was generally based on family and basically brought self-sufficiency, resulting in poor population mobility (Myers, 1970; Jacobs *et al.,* 1995). Additionally, due to primitive production tools in the small-scale peasant economy and the limited knowledge of peasants about agricultural technologies, it was difficult to create a large-scale intensive agricultural industry. Then in the case of natural disasters and accidents, the ancients were disorientated and without the ability to resist these (Jacobs *et al.,* 1995: 30). Hence, in order to survive, people had to take more measures against disasters by forming clans on the basis of connection between consanguineous families and gathering more power (Myers, 1970; Rawski, 1972). So the fear of the environment uncertainty (the ignorance and reverence for 'heaven'[8]) and the nature of survival intensified the people's interdependence (Rawski, 1972), which is also the origin of *guanxi*. Therefore, the social relationships between Chinese people were built mainly on the basis of the family or clan afterwards (Tsang, 1998). The effect of this was that people lived their lives focusing on family, and were accustomed to analysing and dealing with problems from a familial point of view, making the family a standard of judging right and wrong, in connection with which there were no common public criteria (Hsiung, 2013). When everything was done in the interest of family, over time, this became a fixed principle of conduct to ensure personal interests under latent rules; resources would be allocated preferentially to family members.

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[8] "Unlike the Westerner who often prayed to God, the Chinese though of heaven only when in trouble" (Jacobs *et al.,* 1995: 30).

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Second, the formation of latent rules is affected by the feudal autocracy political system. China's traditional small-scale peasant economy decided the political system of feudalism, and provided solid material and basis for the continuous development of feudal autocracy. So with a small-scale peasant economy, Imperial China lasted for thousands of years, marking the peak of feudal autocratic monarchy (Feuerwerker, 1984). With the later economic and social development in China, social circles (networks) were gradually expanded to those outside the family and clan, such as classmates, after the emergence of the imperial examination system, and townsmen when travelling, conducting business, or acting as officials outside their towns (Chen *et al.,* 2013; Hwang, 1987; Zhuang and Xi, 2003). However, the feudal autocracy system was characterised by increasingly greater imperial authority and strict hierarchy, and society as a whole formed a unique power structure focused on imperial authority, with the nobility and bureaucrats coming after imperial authority, by which almost all resources of the society were controlled. One had to possess the appropriate powers to obtain compatible interests, resulting in the worship, desire, and pursuit of personal power and thus gradually forming the self-serving individualism (Wu, 2001). Nevertheless, individualism here does not mean that people persisted in their own ways, but in pursuit of self-interest[9]. A human being is by nature an emotional social animal and fundamentally relation-oriented (Hsiung, 2013; Wank, 1996; Park and Luo, 2001; Luo, 1997), and these emotions may form a connection that is very important for personal development and interests pursuing. In addition, it also shows a relation of personal dependence. In the thousands of years of Chinese feudal society, in terms of social structure, the patriarchal clan system with consanguineous ties was most typical (He, 1998), and the family was the smallest and most basic unit in the society, which the "five cardinal relations" (*Wulun*) built based on family relations had gone beyond, but the human cardinal relation (*lun*) was still considered a great trait in the Chinese social system (Tsang, 1998; Confucius, 1915; King, 1991; Fei *et al.,* 1992; Huang *et al.,* 2013; Hsiung, 2013). This trait was characterised by *guanxi* that made people pay more attention to *'renqing shugu'* (worldly wisdom) in social contacts (not just

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[9] The ancient Chinese society advocates collectivism rather than individualism like North American (Jacobs *et al.,* 1995; Yum, 1988; Dunning and Kim, 2007), but this 'collectivism' is under the control of emperor, nobilities and bureaucrats, whose personal power is huge; for example, the emperor could determine someone's life or death.

restricted to families) and gradually play down formal procedures, particularly legal ones. According to Jacobs *et al.* (1995), "rule by man" means that people like top decision makers (the feudal officials or the emperor) have unlimited powers in making a legal decision, being above the law, resulting in abuse of power and ignorance of formal rules. The autocratic concept of preference for "rule of man" over "rule of law" was entrenched by then, with the result that "rule of law" was rarely advocated. Although time goes by, this concept is still rooted in every Chinese person's mind, so that informal rules like *guanxi* used by man could still play an important role in Chinese society.

3.3.2 Political and economic institution change in modern China

This thesis is about how SMEs obtain funding in China and the role of *guanxi* is closely involved in this process. However, since China is a unique country which is undergoing social transformation, so not only culture, but also other institutional change such as policy change could affect *guanxi*, and *guanxi* could ultimately affect lending. It is therefore very important to present the background of modern Chinese economic history, particularly the part involving the evolution of privatisation which gave rise to SMEs in China. The word 'historical' in the section title refers mainly to the history of economic policy changes in China. In general, how *guanxi* has evolved with the changes of formal institutions in modern China is introduced in this sub-section. The modern Chinese economic history is divided into three periods here: the planned economy period (1949-1978), the economic reform (1979-1991) period, and the socialist market period (1992-present).

The planned economy period started with the establishment of the People's Republic of China (PRC) in the 1949 and lasted for about 30 years. During this period, the Chinese Communist Party (CCP) took over the country and implemented a highly planned economic system. After the Socialist Revolution in 1950-1956, all the resources in the country were allocated by the central government. For example, at the macro level, all the industries such as the steel industry were controlled by the government and became state owned; at the micro level, the central government offered jobs and even food to the citizens (Gong *et al.,* 2013). The concept of the open market and privatisation did

not exist in this period, when everything belonged to the government (Zhang and Ong, 2008).

The main reason why the CCP implemented this economic system is that the country was in the aftermath of war at that time and in desperate need of goods and materials; the planned economic system can make it easier to manage all the resources in the country. There are advantages and disadvantages to this kind of economic system. The advantages are that it was easier for the country to recover from the war if all the resources were allocated by the central government, and that people were guaranteed jobs and foods. The disadvantage are that the market was not free and open at that time, individualism was denied and each one had his role in the organisations; people did not have their own identities but were just allocated like robots to keep the machine of the whole country running (Bian, 1994). In this period, in order to maintain the stability of the society, the government advocated the concept of regulating oneself, taken from Confucian philosophy. People were required to deny their personalisation, work as robots and take different roles in the organisations. The *guanxi* between them was defined as role-based hierarchical *guanxi* and existed mainly in urban areas at that time (Gong *et al.,* 2013).

In rural areas the connection with the central government was looser than in urban areas, and the villagers lived a freer life. They did not need to follow the rules of the central government strictly. Thus the *guanxi* between villagers was more flexible. Fei *et al.* (1992) defined this kind of *guanxi* as egocentric relationship networks. Based on Fei's research, Gong *et al.* (2013) summarise it as soil-rooted egocentric *guanxi* in which "lies in the freedom that it offers to the self in the center of the network, rather than the role that the self is assigned to in a hierarchical structure" (p.364). They also consider that this kind of *guanxi* does not constrain a person with responsibility for his role in an organisation, but offer him personalisation and help to achieve his own goals.

Indeed, the soil-rooted *guanxi* has helped to improve the financial liberalisation reform of China. A very good example is the creation of the household responsibility system by a few villagers. The working situation in rural areas was also different from urban

areas at that time. Before the implementation of the household responsibility system, all the land and food produced belonged to the government. Individuals were not allowed to keep the food they produced directly, but turned it in to the government first, and then the government allocated it to everyone. Every resource was allocated through central planning (Xu, 2003) and the privatisation of goods was illegal, in what is called the people's commune system or collective economic system (Crook, 1975). The advantage of this system is that everyone can obtain food, while the disadvantage is the low efficiency, as everyone obtained the same amount of food no matter how hard he or she has worked (Kestenbaum and Goldstein, 2012). As a result, no one would like to work hard and the food production was low, which also leads to starvation.

Under this background, a group of villagers based on soil-rooted *guanxi* in Anhui Province decided to implement the household responsibility system. North consider the creation of this 'incentive structure' proves that it is not a necessary for developing countries to copy western institutions, since this incentive institution helps China develop rapidly afterwards (North, 2005: 159). However, the household responsibility system advocates family-oriented agriculture and calls for individualism and utilitarianism. And at that time in China (in 1978), such kind of innovative behavior was considered illegal and people who conducted it would be punished (thrown into prison or even death). Rely on the strong soil-rooted *guanxi* in the village, the leaders of the group claimed that they would be responsible for allocating lands to households. And if they were sentenced to death, the rest of the villagers were supposed to raise their children until they are eighteen years old. This system highly inspired the peasants and improved the productivity. If not the strong soil-rooted *guanxi*, this kind of reform may never happen in China (Gong *et al.,* 2013).

Fortunately and finally, the central government accepted this system and spread it to the whole country, which was also the beginning of China's economic reform (Kestenbaum and Goldstein, 2012). In 1978, the reform and opening up policy[10] was issued by the

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[10] The reform and opening-up policy is a policy that China issued in 1978, and which includes two parts: First, the reform inside China: abolishing the people's communes, implementing the household responsibility system, and a gradually shift from the planned economy to market economy. Second, the

third session of the Eleventh Party Congress of the CCP. Since then, the economic environment in China has been changed significantly. In 1984, the Chinese economy shifted from a planned economy into a planned market economy. Since the establishment of Shanghai Securities Exchange markets in 1990 and the Shenzhen Stock Exchange market in 1991, privately-owned enterprises including SMEs were allowed to go public (Li and Liu 2001-a). The influence of the shift to Chinese SMEs was also significant: limited privatisation was permitted and privately-owned small and medium firms (SMEs) emerged after this.

In 1992, the Fourteenth Party Congress of the CCP decided that the goal of China's economic system reform was to establish a socialist market economy with Chinese features[11] (Deng, 1992). The socialist market economic system further reduced the limitations of privatization and inspired the establishment of SMEs. In 1994, China's National People's Congress passed a new Company Law approving the operation of private stock companies (Fang, 1995). This was a huge breakthrough in enterprise privatisation in China; an increasing number of SMEs emerged after the congress. In 1995, the Central Bank Law was passed, the central bank could make monetary policy independent of local government, and which reduced the influence of local government on credit allocation decisions. In the same year, the privatization of SOEs started, many SOEs transferred into private-owned or semi-structured enterprises after that. During this period, most enterprises were still state-owned, but many were transforming from state-owned into privately-owned or semi-structured. Since privately-owned firms had just emerged, so there were only a few private level transactions and the business *guanxi* concept in this period was mainly business to government *guanxi* (Qian, 2000). The function of *guanxi* was also changing during this period, people who had good *guanxi* with the government could benefit from it. For example, if a state-owned textile factory was near bankruptcy, the factory director himself or anyone who had a good relationship

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opening-up to other countries: opening trade ports, building up special economic zones, attracting foreign investment etc.
(From http://www.chinaorbit.com/china-economy/china-politics/china-economic-reform.html)
[11] The socialist market economy is different from the market economy. The market does not function freely but under the control of the CCP's governance. In order to achieve the goal of communism, a group of people are allowed to become rich first, and then they are supposed to help the rest. (Deng, 1992)

with the Department of Industry could buy these state-owned properties (such as textile machines inside the factory or even the whole factory) at a relatively low price. *Guanxi* was a lucrative profit-making strategy here since the price of the properties sold was usually much lower than the market one (half of the market price or even lower). And the factory subsequently became privately-owned or semi-structured. (Gold *et al.,* 2002).

Garten (1998) argued that "China's government will be far less important to business than the officials who are in charge. More than any other large country, it will be a system not of laws and institutions but of people and relationships" (Garten, 1998: 173-174). Indeed, many researchers consider that *guanxi* is very important on business operations (Yen *et al.,* 2011; Dunfee and Warren, 2001; Hsiung, 2013; Huang, 2008). However, recently, certain researchers consider that *guanxi* is less important than it was previously since China is transferring from a relation-based society to a rule-based society, and market economy and rational law have been developed in China (Selmier, 2013; Wu, 2008; Landa, 1981; Li, 2004; Guthrie, 1998). From the above, it can be seen that the political and economic institutions of China have changed with time, and so has *guanxi*. Moreover, formal institutions (i.e. policies) have a reciprocal effect with informal institution (*guanxi*) during their changes, which could ultimately have impacts on the economic behaviours such as SME lending. Chapter Eight will discuss this 'mutual effect' in detail.

3.4 Data collection

3.4.1 Snowball sampling and *Guanxi*-oriented snowballing

Snowball sampling is a technique of using initially sampled research participants to introduce other new potential participants who share the same background or experience, making contacts with them and completing the sampling of the research (Bryman, 2016). Noy (2008) states that snowball sampling is always used in the situation that when it is hard or impossible to reach feasible samples. How to access and obtain relevant data is very important. However, many researchers find it is very difficult to collect empirical social research data by adopting purely 'orthodox Western research methodologies' in Chinese society, especially in face-to-face interviews (Kriz *et al.,* 2014: 30; Liu, 2017).

This is due to the cultural difference that Chinese prefer to transfer information to someone they know well or within exclusive network and circles, since China is a low-trust society (Luo, 2007a; Wang, 2007; Kriz *et al.,* 2014). Hence, strangers introduced by snowball sampling, which is a type of *shengren guanxi* (see Chapter 2) in the Chinese context, are considered anathema and not traditionally welcomed in China (Yang, 1993; Chen, 2001), ultimately affecting the access to and availability of information of the research (Roy *et al.,* 2001). Peng *et al.* (2001) point out that China has its own ideology, which is reflected in native research approaches and issues that could create barriers to applying Western theories and methodologies. This adds the complexity in gathering sufficient information by simply adopting Western methods (Tsui, 2009). Thus, many researchers have called for the development of new methodologies which are suitable for Chinese research (Liu, 2017; Kriz *et al.,* 2014; Tsui, 2009).

Kriz *et al.,* (2014) proposed the possibility of *guanxi*-oriented snowballing as a new research tool to collect qualitative data in China firstly, and they used in-depth interviews to prove that it was an effective and feasible method. According to Kriz *et al.,* (2014), the *guanxi*-oriented snowballing method is "a snowballing-style process through *guanxi* referrals and recommendations", so it is similar to Western snowballing in sampling, while the biggest difference between these two kinds of snowballing is "the extent and the level of cultivation that exists in a referrer's network". This means the *guanxi*-oriented type requires more intensive interactions and a closer relationship between referrers and referrals (Kriz *et al.,* 2014: 36). Hence, the subject of the research, *guanxi* in this present thesis, could also be used as a tool to gain access to interviewees and gather sufficient and valid data. Indeed, the *guanxi*-oriented snowballing technique is actually a very important data collection method used in this research. Three initial formal interviewees were people I already knew and had previously interacted with (either friends or relatives). Nine interviewees (two of them were also pilot interview interviewees) were introduced directly by my family or relatives, while five interviewees were introduced indirectly by my family or relatives' close friends. This means the *guanxi* level between theses referrers and referrals were strong, and according to the literature in the literature review chapter, the *xinren* (trust) beneath this *guanxi* could actually be transferred to the researcher, which means the interviewees could also

trust the researcher well. So that the access to the information could be achieved, and validity of the data could be ensured. Only two interviewees were found with the snowballing technique; these were introduced by the interviewees that I had interviewed. The choice of the samples was made without special purposes, but simply because they were SME owners or people from the banking industry and thus relevant to this research, and because the referrers knew them.

3.4.2 Ethnography and participant observation

Ethnography is a means or method of studying culture or people's behaviour and interactions in social groups, which requires researchers to insert themselves into the daily activities of the research subjects, to participate and observe from their standpoint, and finally to describe what they see and observe (McNeill and Chapman, 2005; Bryman, 2016). The main purpose is not to seek explanations or causes, but to 'tell it like it is' and understand the 'social meanings and ordinary activities' of research objects (Brewer, 2000: 6, 38). This thesis researches people's economic behaviour (SME lending) within the context of cultural embeddedness (*guanxi*). In addition, as an interpretivist research, ethnography is adopted here as an appropriate approach, since the interpretive tradition of social research generates ethnographic studies (McNeill and Chapman, 2005). The ethnographic method requires an in-depth observation and understanding of research subjects through field investigation, so an additional advantage of this present researcher is that as a Chinese person who grew up in this cultural setting, I have a deep understanding about the role of *guanxi* in Chinese people's daily lives.

Ethnographic research comprises two data collection methods, which are participant observation and interviews (Bryman, 2016). Qualitative data are collected through the participant observation method (Burgess, 1984) and semi-structured interviews (Bryman, 2016) with SME managers and LMs from some financial institutions and SMEs in China (see appendix, table 3.1). During the fieldwork, the researcher went to several banks and SMEs to observe how credit is granted in practice. The processes of fieldwork involve participant observation, including finding and interacting with interviewees, observing the fields of SMEs and financial institutions, participating in

the lending process and observing people's behaviour during this process. For example, some data were collected through social interactions and activities like having dinner with the participants. And it is found in this research that the participants were more frank and relaxed in releasing some information in these events.

Another important part of participant observation is field notes (Bryman, 2016). A field report was written for each interview, and some short field notes were taken during or after field visits or social events, mainly describing the fieldwork process and some key points before or after the interviews, as this helped me to recall the details subsequently. For example, I have a personal connection through a relative to the owner of a micro-credit company, the following paragraph comes from the field note from the interview with LM1:

> Accompanied by X, I met LM1 in his office again for the formal interview. LM1 is actually my first interviewee (of the pilot interviews). I was a little bit nervous when I met him last time since that was also my first time to conduct a relatively formal interview. But this time I could talk with him freely like friends, and I feel that he also talked to me openly, since he told me all the things that he knew without hesitation. […] X also considers that LM1 is open and frank to me since he is a trustworthy guy.

Observation is essential and important in this research. The records of field notes and reports could enhance the richness of data and thus reduce the sample size limitation of this research to some extent. Besides, it is also used to identify the truth of information provided by the participants by comparing their words and their behaviour from observation, which will be discussed later. The next sub-section explains the main method of data collection, which is about how interviews were conducted to collect data for this research.

3.4.3 Interviews

Three rounds of fieldwork/interviews were conducted in China in order to achieve the research objectives. The pre-understanding fieldwork was carried out during the

Christmas vacation in 2013. I carried out five informal interviews (through conversations) with LMs from three banks during this pre-understanding fieldwork. However, the purpose of this fieldwork was not to obtain specific research data, but to gain a rough idea of what type of primary data could be obtained, and of the real situation of SME lending in China, as well as to prepare for the further research design. So these pre-understanding interviews are not counted in the total sample size as shown in table 3.1, since the data collected are not presented and used in the empirical chapters of this thesis. These LMs gave me an overview of how lending technologies were applied by local banks to make loans to enterprises, and during this time, *guanxi* was frequently mentioned by them. Therefore, after this pre-understanding fieldwork, *guanxi* was considered by the researcher as a research object for the analysis of SME lending in China, and an in-depth semi-structured interview approach with open-ended questions was chosen as the data collection instrument. According to Bryman (2016), a semi-structured interview means that the researcher uses an interview guide which includes a list of questions that cover specific topics. In addition, "Questions may not be asked exactly in the way outlined in the guide on the schedule. Questions that are not included in the guide may be asked as the interviewer picks upon interviewees' replies", which means that this approach is very flexible and the researcher could take some immediate action (i.e. ask new questions or ask questions in a different way) corresponding to the interviewees' responses during the interviews (Bryman, 2016: 468).

The second round of fieldwork was conducted in December 2014 and comprised two pilot interviews. One pilot interviewee was from a micro-credit company (MCC) and the other from a city commercial bank (CCB). Some interview questions (see Appendix IG1; the words in red signify the purpose of asking these questions and the information that I wanted to obtain from these questions) were designed before the pilot interview, and the purpose of these interviews was to test these questions, gain interview experience, find more research topics and finally form appropriate formal interview questions. Briefly, pilot interviews are a preparation for the formal interviews and help the researcher learn how to conduct interviews well. Moreover, after analysing the pilot interview transcripts, some questions were revised and more specific questions were

added, meaning they were much closer to the research purpose and subjects. The third round of fieldwork was conducted from May to September 2015; 18 formal, in-depth interviews were conducted during the period. The interviewees comprised 9 staff members of financial institution (including the two pilot interviewees), who were either branch presidents, branch vice-presidents, director of credit review department, risk control department manager or customer managers (are all called loan managers hereafter), and 10 SME managers. LMs and SME managers were asked different questions (see Appendix IG2, IG3), and the two interviewees from the pilot interviews were asked some supplementary re-interview questions (see Appendix IG4), in order not to repeat the pilot interview questions (see Appendix IG1).

Some basic background information about the interviewees is presented in table 3.1 in the appendix. The interviewees were from financial institutions and SMEs in four cities in China. One city is one of the largest in China, while the other three cities are relatively small and in a province in south-east China. The target province is very famous for its private enterprises in China; SMEs in this area are also very typical of manufacturing enterprises in the whole country (Liu, 2008). This is why I chose this province as the research area and the manufacturing SMEs there as research subjects. There are four types of financial institution involved in this research: micro-credit companies (MCC), state-owned commercial banks (SOCB), city commercial banks (CCB), and joint-stock commercial banks (JSCB). The LMs were from two of the 'Big-five' SOCBs, two JSCBs, three CCBs and one MCC. The SME managers were from some manufacturing SMEs in south-east China, who were representative of Chinese SME managers broadly. The loan manager's main job is sorting materials and investigating customers, while some LMs are also required to develop and maintain customers after the lending. Brief introductions to the interviewees are presented in table 3.1, and due to confidentiality and anonymity considerations, since some information is very sensitive, details that show their true identity have been removed here.

The formal interviews were conducted in Chinese (Mandarin) and local dialects; participants were encouraged to choose to speak in whichever they preferred. Most of the interviews were recorded using a digital voice recorder while the rests were recorded

with a mobile smartphone. I had prepared some fixed interview questions in the interview guide in advance (see Appendix), but since most of the interviewees were very positive and active, a number of open-ended and new questions (which followed the interviewees' responses and logic of speech) were also asked during the interviews; the order of the questions could also vary from the interview schedule. In some formal interviews (i.e. T-7), only a few prepared questions were asked, since their time was limited and the interviewees talked a great deal themselves. The average interview lasted about one hour, while some exceeded one and a half hours. All the records were transferred to my personal computer and kept secret.

3.5 Data analysis

As an applied qualitative research, the thematic analysis and Framework Analysis (FA) approaches are adopted in this thesis to analyse the research data. Thematic analysis is a widely-used approach, and rather than explain it in detail here, I will offer a very brief introduction to it. Despite its wide usage, and unlike other methods (i.e. grounded theory, narrative analysis) which have clear structures, thematic analysis is a contentious method, and is considered as an indefinable data analysis approach since there is no very clear definition of or guide to this method (see Bryman, 2016; Braun and Clarke, 2006). However, Braun and Clarke (2006) attempt to define it as an analytic method which could be used to identify, analyse and report themes within data. Based on their previous 2006 work, Clarke and Braun (2013) propose six phases for conducting thematic analysis: familiarisation with the data, coding, searching for themes, reviewing themes, defining and naming themes, and writing up. Due to the indefinable nature of thematic analysis, this research also applies the FA in its data analysis. Lacey and Luff (2001) consider FA to have many features in common with of thematic analysis, but to be more systematic and able to provide clear, visible steps in data analysis. In addition, in contrast to grounded theory, FA is particularly suitable for qualitative research with pre-designed samples and *a priori* issues (pre-set questions) that need to be addressed (Lacey and Luff, 2001; Ritchie and Spencer, 2002), which corresponds to this research. Ritchie and Spencer (2002) conclude that there are five steps of FA: familiarisation, identifying a thematic framework, indexing, charting, and mapping and interpretation

(Ritchie and Spencer, 2002: 312). Familiarisation means that the researcher should become familiar with the research data by listening to the interview records and reading the transcripts. The second, third and fourth steps are actually the coding process of the research data, which means the researcher should set up themes and charts, pick out data which have similar backgrounds from different transcripts and put them together under the same theme. Mapping and interpretation refer to "searching for patterns, associations, concepts, and explanations in your data, aided by visual displays and plots" (Lacey and Luff, 2001: 15). The analyst should "map and interpret the data set as a whole", which is a "systematic process of detection" (Ritchie and Spencer, 2002: 320).

Based on the thematic analysis and FA, the first step of the data analysis in this research was the transcribing and translating of the interview voice records (Lacey and Luff, 2001). During the transcription process, since some of the interviews were recorded in local dialects (which are quite different from the Mandarin), in order to make sure the interviewees' meanings were translated accurately and to minimise misunderstandings, for example, the researcher had to listen to one sentence several times and 'translate' it into Mandarin. All the interview voice records were transcribed into Chinese text first, and then certain transcripts were fully translated into English. Each interviewee was given a code and each transcript was given a number for confidential purposes (see table 3.1); all the names and other identifiable materials were removed from the transcripts (Lacey and Luff, 2001). The familiarisation process also started during this process. However, after fully translating several transcripts, since the research data was so rich (the transcripts word counts range from about 4,000 to 27,000 Chinese words, the average number is about 12,000 Chinese words and 10,000 English words after translation), the researcher found it was too time-consuming and impractical to translate all the interview transcripts into English (this would have resulted in about 200,000 English words in total). The researcher therefore changed the strategy. After finishing coding the fully translated transcripts, the researcher started indexing the rest of the Chinese version transcripts by cutting and pasting electronically (Lacey and Luff, 2001), dividing them into parts of quotes pieces, putting them into different thematic charts, translating them into English ultimately to be used in this research. In addition, there were two different stages of coding; the initial coding came after analysing the pilot

interview transcripts, when some provisional codes were found, so some themes (i.e. common friend *guanxi*) were chosen even before the formal interviews, while in the second stage after the third round fieldwork, more themes were found after analysing all the research data. All the coded data were distributed into four 'central themes' with several 'sub-themes' under them (Bryman, 2016: 585). The four main themes are: Financial statement problems in China; practices of loan information collection, evaluation and approval; implementation of *guanxi* in the lending process, and; the role of *guanxi* in the lending decision. These form the four empirical chapters. The last step of FA is mapping and interpreting the coded themes; theories (i.e. embeddedness theory and institution theory) are applied to discuss these themes, as presented in the discussion chapter (Chapter 8).

3.6 Ethical considerations

Ethical issues are a very important concern of this research. Confidentiality and anonymity of research participants were applied throughout the research. Since some information is very sensitive, in order to protect the interviewees, details that could be used to trace participants' true identities are all removed in this thesis. Each participant was required to sign an Informed Consent Form before the interview. In the form, the participants were informed that the data collected from them would be kept confidential and used for academic research only. With the participants' consent, the interview would be audio recorded to help the researcher's further research. However, the participant's name and other identifying information would not be associated with any part of the written report of the research. All of the participant's information and interview responses would be kept confidential and the researcher would not share any individual responses with anyone other than his supervisors. The participants were further informed that the purpose of this study is to examine funding practices of SMEs in China, focusing on the relationship between LMs and SME managers. The benefit of their participation was explained as being to contribute information to develop a better understanding of current Chinese SME lending and help to improve it. This may assist current and future scholars to expand their research scope. The participants were also informed about the interview procedure, and that the interview would last

approximately 30 to 60 minutes. Key questions concerned the process of making loans to enterprises in practice and so forth. The participants were also encouraged to ask questions or raise concerns at any time about the nature of the study or the methods. The participants were told that they were not obliged to participate in this study, and the interview would be conducted according to their own agreement. They could ask to stop the interview if they were not comfortable with it at any time, and there would be no negative consequences of non-participation.

Other ethical issues could arise from the participant observation (Burgess, 1984). The researcher took part in some lending processes to obtain relevant data and information, so he could observe clearly from inside these institutions. However, some information and data were sensitive and these institutions may treat them as secret; therefore the researcher respected their rules and ensured that this kind of information was not released to a third party.

3.7 Reflections

Before the fieldwork, I thought it might be difficult to obtain valuable and valid information for this research, since Chinese people are normally introverted and do not like to talk much, especially about sensitive topics. However, the outcome far exceeded my expectations; the data obtained are rich and of high quality. It was found from the interviews that some interviewees were eager to express themselves; a few interviews even lasted more than one hour and forty minutes, many exceeded the planned one hour. Although the interviews were designed to be semi-structured with pre-designed questions, since the interviewees had such a strong desire to express themselves, the priority was to let them do so freely. In this case, the questions asked in each interview varied slightly, and not all the designed questions were asked in every interview. An extreme example is the interview with EM7. I did not ask many questions but he shared all his own experiences, opinions, and attitudes about Chinese SME lending to me himself. The entire interview was like a monologue from the start. I did not stop him but let him speak. I think this was partially due to the use of the *guanxi*-oriented snowballing method to find interviewees, since most of the interviewees were

introduced by someone they know well, meaning that they were not defensive with me and wished to share great deal of detailed information. Furthermore, I also provided my PhD student status to them before each interview, and informed them that all the data were only for research purposes. The strategy of interview is that I just follow the interviewees' speech and logic, guiding them to reveal information and refer to some specific important topics by asking questions when necessary, if the interviewees did not mention it by themselves. In this way, a satisfactory result was obtained.

In addition, several techniques are used to ensure the validity of data obtained especially the more sensitive data. For example, when I was asking about the bribery situation in China, for some more closely acquainted interviewees, I would have dinner and drink some wine with them before the formal interview. In this relaxed atmosphere, they were more frank and open with me, with the result that they would even use the words 'corruption' or 'bribes' directly in the interviews. For others who were not that familiar, I asked them in a mild and indirect way, using the word 'gift-giving' rather than 'bribes' during their interviews. Since the Chinese language is a high-context language, this means there could be two meanings (one surface meaning and one implied meaning) for the same word, or that very simple words could represent very complex unspoken meanings, and sometimes these unspoken meanings are more important the spoken one (Hall, 1976). Indeed, because 'gift-giving' does not necessarily mean corruption, normal gift exchange is also very common in China, I think it made them feel more comfortable by asking in this way, since bribery and corruption are very sensitive topics in China. The outcome shows that this technique achieved its purpose, since their responses (information provided) show they understood what I meant (see Chapter 7). In fact, the application of this technique also involves the 'indirectness' feature which is embedded in interpersonal *guanxi* and Chinese culture (see Chapter 8). Furthermore, the judgement of the truth of the information provided by the interviewees depends not only on what they said, but also on the comparison between their words and their behaviour during observation. For example, many interviewees (i.e. LM3, EM3 and EM4, see Chapter 7) emphasised that they had nothing to do with bribery, while, they all admitted it happens in the banking industry, exists in other banks and could affect

lending decisions. This kind of contradiction in observation in fact enhances the validity of the information.

Most of the studies on *guanxi* are theoretical and have rarely been tested empirically. This research aims to fill the gap from a cultural and institutional perspective, through the methods of participant observation and interviews. The originality of the research is that it is based on primary data. The strength and efficacy of *guanxi* between financial institutions and SMEs in China are measured. Ultimately, through thematic analysis and framework analysis, the study aims to determine what role *guanxi* plays in the availability of credit to Chinese SMEs and whether it can be regarded as an efficient approach to reduce the malfeasance problem and financial constraints. The next chapter is the first empirical chapter of this research, and presents the current accounting environment and problems in Chinese SME lending.

Chapter Four: Financial statement problems in China

4.1 Introduction

As discussed in the literature review, invalidity and inaccuracy of accounting information pose constant problems for Chinese SMEs; accounting scandals such as financial statement frauds (FSF) or financial statement manipulation (FSM) are very common in China (Xuan, 2002; Wu, 2002; Chen *et al.*, 2011a). Copeland (1968) defines accounting manipulation as the ability to smooth reported net income on purpose; corporate managers increase or decrease the incomes deliberately, as they wish. Stolowy and Breton (2004) reviewed many studies on financial statement manipulation (FSM), and define accounting manipulation as being where an enterprise manager uses his or her power to manipulate accounting reports and then transfers wealth between the company and fund providers, so that firms and managers can benefit from the wealth transfer. They also conclude that there are various techniques of FSM: "earnings management, income smoothing, big bath accounting, creative accounting, and window-dressing" (Stolowy and Breton, 2004: 5). Rezaee (2005) defines financial statement fraud (FSF) as enterprises' attempts to use misstated financial statements to mislead or deceive financial statement users, especially those external financing providers. He concludes that FSF may also involve some deliberate schemes such as "falsification, alteration, or manipulation of material financial records, supporting documents, or business transactions" (Rezaee, 2005: 279). Furthermore, Rezaee (2005) considers that there are various kinds of FSF; revenue fraud is the most commonly occurring kind, while accounts payable is the least common. Beasley *et al.* (2000) investigate fraudulent financial statements in three industries, finding that revenue fraud and assets fraud are the two most common FSF techniques used by the sample fraud companies. Brennan and Mcgrath (2007) study 14 companies from the US and Europe, and find that the most common fraud method used by these companies is recording false sales, which concerns sales fraud. Chen *et al.* (2011a) analyses seven Chinese accounting scandal cases and finds that there are several FSF techniques frequently used by enterprises: sales fraud, manipulation of capitalising expenses and inflated asset value.

Previous studies have addressed the problem of accounting information fraud and related accounting scandals, noting that, although there have been some improvements in the quality of audits in the Chinese accounting environment, many accounting information fraud cases are still reported (Xuan, 2002; Wu, 2002; Firth *et al.*, 2005). Most of the interviewees (both LMs and SME managers) in this present study believe that most financial statements in China are still unreliable. A few indicative examples of this belief are the following: SME manager 10 (EM10) from a small enterprise said, *"All of our financial statements are fake"*. (EM10: Transcript 18, P.10), while, according to SME manager 2 (EM2), *"If you examine it carefully and formally, then no enterprise will dare to say that there is absolutely no problem with its financial reports"* (EM2 and EM3: Transcript 11, P.13). Another interviewee, loan manager 9 (LM9) stated, *"Many loans, especially loans to small enterprises, I can tell you that nearly 99% of them have problems. [...] Most of the financial statements are fake and useless"* (LM9: Transcript 9, P.8). LM8, who is from a joint-stock commercial bank, went even further than LM9's claiming, *"Many things like financial statements, 100% of them are false"* (LM8: Transcript 8, P.4, 12). In the same vein, LM2 said, *"Your financial statements can be fake, your bank statements can be fake, your inventory change records can be fake, and even your working field can also be fake"* (LM2: Transcript 2, P.10). These statements were made in the stages of the data collection, and I had also heard some rumors about how poor the accounting statement environment was in China even prior to the data collection. Nonetheless, when I heard these statements from my interviewees first-hand and in person, I was still shocked, by assertions such as EM10's to the effect that all of their financial statements are false. Indeed, it was not only the aforementioned interviewees who made such claims; the majority of the; most of my interviewees mentioned similar phenomena.

Hence, motivated by these initial statements from LMs and SME managers, I wished to investigate about the current financial statements environment in China in greater depth in this section. There are two main sections in this chapter: the first section (4.2) shows the current situation of fraudulent financial statement in China; the second section (4.3) explores the awareness of both parties (LMs and SME managers) of the financial

statement environment. The first section presents some current situation, as well as certain important elements from the environment in which financial information is being used as part of loan approval to SMEs in China. The second section is more significant, because it shows that it is not only the borrowers (SME managers) who decide to falsify their accounts, but that there is an entire system of incentives that motivates all participants to falsify information and accept false information. It shows the incentives and motivations that contribute to the continued existence of the environment in which false financial information is knowingly generated and acted upon.

4.2 The current accounting information environment in China

4.2.1 An environment of invalidity and inaccuracy

One of the most telling pieces of the evidence which frame this part of the findings comes from LM1, president of a micro-credit company. LM1 explained that at his company, they do not require any of the typical forms of evidence such as financial statements or bank statements from their SME customers. He also explained why this is the case:

> "It is because we doubt the authenticity of Chinese enterprises' financial statements, they are not that trustworthy". (LM1: Transcript 1a, P.1)

> "We do not need these since they are all false from our perspective; the results are meaningless if we analyse these false financial data." (LM1: Transcript 1a, P.8)

In the first quote, LM1 uses lighter words, such as "doubt" and "not that trustworthy", meaning that they doubt the authenticity of Chinese enterprises' financial statements, and consider that these financial statements are questionable and not trustworthy. However, in the second quote, he uses much stronger words, such as "we do not need" and "they are all false". This change in tone is quite interesting. This could be attributed to his becoming more open and frank with me, and more willing to express his true opinion as the interview proceeds. LM1 regards financial statements provided by Chinese SMEs as false and therefore useless for making a lending decision, a view

which was repeated by other interviewees, as will be presented later. This also the reason why LM1 uses methods other than financial statements to investigate his customers during the lending process, as will be discussed in later chapters.

LM3, who is a LM from a city commercial bank, also noted the inaccuracy and incompleteness of Chinese SMEs' financial information:

> "I think Chinese enterprises' financial statements are more or less all have false financial data; it is a common situation in China. […] To be honest, you can 'cook the books'." (LM3: Transcript 3, P.9, 19)

Compared to LM1's 'all false', LM3's attitude towards the truth of FS was more positive. He used less strong words like 'more or less' to describe the situation in China. However, I think the "more or less" also means that LM3 considers that Chinese SMEs do manipulate and falsify financial indicators; the percentage of falsification may differ in different enterprises, but the phenomenon is still common in China. Some SMEs may only falsify some indicators on the financial statements, while others, like EM10, may falsify most of the indicators (EM10 himself admitted that all of his financial statements were fake), which makes Chinese SMEs' financial statements all 'more or less' problematic, and not completely true. Details of this situation will also be presented in the next sub-section.

LM4 expressed quite similar sentiments:

> "You can even check those listed companies; can you find one that is not falsifying the financial statements? No, you cannot. This is one hundred percent for sure. I am not saying that they are doing it illegally, but within the policies and rules, there is still a lot of space (to manipulate it). So, we cannot depend on these accounting indicators." (LM4: Transcript 4a, P.4)

LM4's sayings about window dressing here support some previous studies. After researching accounting fraud and scandals of six listed companies in China, Chen *et al*.

(2011a) conclude that despite the listing requirements and regulations, there are still some loopholes that allow accounting scandals to occur in the Chinese system. Based on LM4's statement here and on previous literature, listed companies are usually more standard and transparent than SMEs, but even listed companies manipulate financial reports in China, not only SMEs. Thus, what LM4 wants to point out here is that the situation is much worse among SMEs, that Chinese SMEs' accounting information is much less trustworthy and reliable. In addition, from the last sentence of the above quote, it can be seen that the lending decision does not depend on SMEs' accounting indicators or financial statements, so what about other LMs and banks?

At the beginning of the interview with LM6, he said their lending investigation relied mostly on the ratios on the statements, which means that financial statements play an important role in loan approval. However, later, when the interview was nearly at an end, he said,

> "Can we trust the financial statements provided by the enterprise managers ? No, we cannot." (LM6: Transcript 6, P.9)

This change in attitude of LM6 is quite interesting, and it appears that there is a contradiction here: although LM6 said the lending investigation relied on the statements (at least superficially), in fact, he seemed not really to care about them. On further examination of the logic behind it, another question emerges: it appears that financial statements cannot provide useful information since LM6 does not trust them, so why does he still rely on these statements? LM9 provides a reasonable explanation,

> "The procedures of lending in state-owned banks are very tedious and complex. The materials are all useless actually; they are just for clearing the responsibilities. When a bad loan occurs, they can be used to track back easily who should be responsible for, so everyone in the bank wants to pass the duty." (LM9: Transcript 9, P.21)

LM9 considers that LMs, particularly in state-owned banks, do not have motivations

to do anything; they only care about their own benefits: try to avoid mistakes, shirk responsibilities and hold on to their jobs. Their first consideration is to shirk their responsibilities, and rather than reducing the risk for the bank, the less their responsibility for each lending transaction, the better. This is LMs' main concern, so they merely use financial information as a tool or proof to shirk their responsibilities, rather than as a real factor to evaluate enterprises validly. LM9 also explained why and how LMs shirk their responsibilities:

> "Everything on surface should look fine, so at least when things (bad loans) occur, the bank can only charge me for dereliction of duty, but not fraud together with the customer. The punishment of these two things are completely different: the bank can only punish you for some amount of money for dereliction of duty; while if it is fraud, since it is against the law, you will be sent to the court and jail. […] So everything on the surface should look fine and I have to make sure it is not my full responsibility." (LM9: Transcript 9, P.9)

According to LM9's explanations in the above quote, the 'look fine' does not simply mean 'look good' here, but implies that LMs should make or help to make the statements look very 'true' even if they are not. Then LMs can use materials like financial statements to minimise their accountability if bad loans occur; they can simply say it is not their duty since the accounting information provided by enterprises looks so true, and that they have also been deceived. This situation arose in reality when I was participating in a lending procedure: I accompanied one of my SME manager interviewees to take a loan from one bank. The manager had already met with the LM, who had agreed to make the loan. During the meeting, the LM spoke to the SME manager: *the total assets on your balance sheet do not reach our lending requirements; ask your accountant to provide another balance sheet with more assets. For example, you may add to the number of the machines in your factory."* This LM's behaviour corresponded exactly to LM9's words. Although LMs know the materials are useless in evaluating an enterprise, they are very careful when dealing with these materials, since they need these to make sure they will not leave them open to any serious responsibility in case of a negative occurrence.

4.2.2 The causes of this environment

The last sub-section shows the environment of invalid and accounting information in China, but what cause this? What are the reasons behind this environment? If we can know the causes of it, then we can understand the role that financial information plays in SME lending, and finally have a better understanding about the importance of non-financial information in this area. In this light, this sub-section tries to explore this question from the perspectives of both the SME and the bank. Many interviewees discussed the reasons why this situation comes about:

> **EM4:** Because they (LMs) have limited rights, they can only find it out through talking with entrepreneurs or SME managers. Since their rights are limited, neither do they have the right to check your financial statements, nor the right to obtain information on your latest circumstances, so they can only do it in this way. This is also a disadvantage for banks.
> **Me:** *So they do not have the right to look at your financial statements?*
> **EM4:** Yes.
> **Me:** *But what if they insist, will you compromise?*
> **EM4:** We can still refuse it. (EM4: Transcript 12, P.8)

EM4 refers here to an important cause of the inaccuracy of accounting information: SME managers are not required by law to provide formal financial statements or audit reports during the lending process, so SMEs or SME managers have more asymmetric information than banks or LMs. Thus, due to the asymmetric information they have, SME managers can take advantage of banks, and they can maximise their own interests (i.e., obtain more loans) by providing false financial statements, and banks face more risks since the probability of bad loans is therefore higher. Thus, the moral hazard problem emerges, which places banks in a vulnerable position. This is also the main reason why financial institutions use various ways to investigate enterprises, and do not just depend on financial statements. LM4, who is from a commercial bank, also talked about his understandings of SME managers and fraudulent financial statements,

"What we can see and verify are only those financial data on the financial statement, so he can overstate those which are not on the statement. If he wants to take the loan, he will only talk about the good things, how many good business transactions he has done and how much he earned last year. He will not tell you about the bad debts or how much he owes to others, this is for sure. We can understand this; it is impossible for him to reveal his disadvantages, we can only dig all these out by ourselves." (LM4: Transcript 4a, P.3)

The above quote verifies EM4's statement from the bank's perspective: given that SME managers are not required by the law to provide formal financial information, banks or LMs can only have access to the information unless SME managers choose to disclose it. At the same time, it can be seen that that there is a widespread absence of trust. From the above quote, it is clear that LM4 does not trust SME managers, but believes that SME managers have the chance to provide inaccurate, invalid but 'nice looking' statements for their own interests and that they surely do this. In this case, SMEs may only provide informal (incomplete) statements or transaction records to banks:

"They may provide some records of acceptance bills, but not bank statements. Besides, we are not able to verify anything through their bank account history. After the discounting of acceptance bills, the money may just go to his personal account, but not the corporate account, so we are not able to verify anything from this." (LM1: Transcript 1a, P.14, 15)

The "acceptance bills" mentioned in the above quote refer to bank notes or receipts such as bank drafts. For example, if enterprise "A" buys some goods from enterprise "B", "A" may not transfer the money through the bank, it just gives "B" a bank draft. And the SME manager of "B" can either put the money into his own personal account after claiming, or just use this bank draft to pay other debts, both of these two ways make it impossible for the cash flows going through the corporate account of enterprise "B". Therefore, in this case, even if B provides bank statements, LM1 is still not able to track and verify all the cash flow records of B, since not all the cash flows are recorded in B's corporate bank account history or bank statements. As LM2 said,

"In this situation, we are not able to know their real incomes since their financial statements are not reliable, and cannot reflect the true condition." (LM2: Transcript 2, P.3)

So as it is indicated from LM1's quote that not being able to track cash flows validly is another likely factor contributing to the limited ability to produce valid accounting statements. Furthermore, LM2 and LM5 mentioned that SME managers use some loopholes in the law to avoid cash flow monitoring, which also leads to illegal activities such as tax dodging:

"When selling products to a downstream enterprise, if the sales amount is not large, the SME manager may not issue a VAT invoice and the money just goes into his personal bank account; in this case, you are not able to track the cash flows." (LM5: Transcript 5, P.20)

As it can be seen from the above quotes, if the cash flows go through personal accounts, SME managers can just hide their incomes and then avoid some tax payments, which is tax evasion behaviour. It also deceives banks or LMs if the money is not recorded on financial statements, and as the interviewees mentioned, this phenomenon is very common in China, making financial statements less trustworthy and reliable. LM5 also gives an example to explain this situation in detail:

"It is common that he says his annual turnover was about 50 million CNY, but after checking all his tax payment receipts and other tax records, the real annual turnover is less than 30 million CNY. Then he will tell you, 'we did it fifty-fifty.' Which means about fifty percent of the turnover went through the corporate bank account and VAT invoices were issued, while the rest went through his personal bank account and he did not pay any taxes." (LM5: Transcript 5, P.20)

For the reasons described above, the tracking of financial indicators such as annual turnover and cash flows is challenging, contributing to the 'omissions' of accounting information for Chinese LMs. Just as EM4 stated previously, it is also verified here that

banks are actually in a vulnerable position; they are not able to obtain full information on enterprises, and they can sometimes only 'listen' to SME managers' words. This is due to the current imperfect institution design in China, and which will be discussed in the discussion chapter (Chapter 8). In addition, from the last sentence of the above quote, it could be inferred that LMs, at least LM5 in this case, are clearly aware of this situation. This is also verified by LM5's use of the words 'it is common' in the first sentence to show his acknowledgement of the situation. In addition, he did not indicate any objection to this behaviour in the interview, but simply acquiesced to and accepted it. At the same time, SMEs try to avoid taxes in this way, which also makes financial statements even more unreliable. Exemplifying this problem is the fact that SMEs

> "[…] may have several different versions of financial statements; maybe one (is prepared) for the government, one for banks, one for the tax bureau and one for themselves." (LM1: Transcript 1a, P.1)

The above quote shows an extension of the example that LM5 gave previously; the SME manager in LM5's example probably also behaved in this way. Maybe the SME manager has provided a true annual turnover in the begging, or maybe not. Let us suppose he was telling the truth, that his annual turnover is truly about 50 million, but this number is not corresponding to the one that LM5 has calculated from the tax payment records (and there is a huge gap between the two), which means he has done some tax evasion or tax dodging activities. Let us suppose he was not telling the truth in the beginning, which means his real annual turnover is much less than 50 million, and then we may suspect he wants to get more loans from the bank by doing so. It is because that the credit line or credit amount that the bank can offer is normally related to the annual turnover, banks always would like to offer more loans to enterprises with higher annual turnovers. However, both of these two cases show the dishonesty of the SME manager here: he has provided false accounting information to either this bank or the tax bureau, which increases the risk for the bank or against the law. This is just a very simple example about the annual turnover here; in reality, SMEs would falsify various indicators on their financial statements, in order to pass the inspection or investigation of different bodies. When there are several different versions of financial

statements, this means not all the financial statements can be true; they are not the same, and thus some versions must clearly contain false information. Therefore, wishing to pass different inspections or investigations is probably another reason why SMEs make different versions of financial statements. LM1 also mentioned in the interview that SMEs might also have different financial statements for different banks, since different banks also have different focuses on the elements or ratios. Therefore, for example, if the enterprise knows that bank "A" prioritises "annual sales" while bank "B" prefers the "debt to assets ratio", then the enterprise may provide a financial statement to bank "A" which shows a higher, but inauthentic, "annual sales" figure. It may also provide a financial statement to bank "B" with a false "debt to assets ratio", which is actually lower than the real one. Hence, different versions of financial statements are given to different banks in order to obtain loans from them.

It is shown in this sub-section that the limitation of rights and the difficulty in tracking cash flows validly are two main causes of the invalidity and inaccuracy in the accounting environment: the limitation of LMs' rights causes the information asymmetry problem and probably gives SME managers a chance to provide false statements, while the difficulty in tracking cash flows validly is another likely reason leading to the inaccuracy of Chinese SME's accounting information. To sum up, these two causes are also due to the imperfect system of account management and supervision in China, which will be discussed in further detail in the discussion chapter (Chapter 8).

4.3 Awareness and incentives of both parties

Following these findings, the research efforts focused on the economic, social and political conditions that maintain this environment in which knowingly untrusted accounting information is used as part of lending decisions. However, prior to this, this section explores in depth the attitudes of both LMs and SME managers towards this environment, and their incentives for doing so. EM10 admitted in the interview that,

> "We are carrying out accounting fraud actually. […] all the financial statements provided to the bank are fake. The bank knows about it perfectly well and they allow you to provide false financial statements." (EM10: Transcript 18, P.6)

This fragment indicates that the problem is both deep-seated and, in the view of EM10 at least, it is acknowledged on both sides and with both sides aware of the knowledge of the other. Another SME manager, EM4 gave a similar opinion:

"Many statements provided to banks are all nothing; banks even ask you to provide false statements. Statements are all nothing, they are all false." (EM4: Transcript 12, P.3)

EM4's words are stronger than EM10's, as he says banks not only know about it but they may even ask enterprises to provide false financial statements, which means banks are also actually involved in this fraudulent activity. Is this true? Do banks also know about this situation? The answer is that they do. The last sentence of LM4's quote in last section (sub-section 4.2.2) shows the acknowledgement of both parties. He is clearly aware of SME managers and how they manipulate or falsify financial statements, but he still accepts and supports these managers' behaviour, which also confirms EM10's previous words. Moreover, LM8, from a joint-stock commercial bank, provided similar information as EM4 and EM10:

"As you may know, accounting fraud is a very serious problem in China. Many enterprises, especially private enterprises, their financial statements are not trustworthy. Actually, we banks know they are false, but we need to do business and make a living, so we do not have any choice but acquiesce to it." (LM8: Transcript 8, P.3)

It is therefore verified here that both parties know many SMEs' financial statements are not reliable and trustworthy. However, as banks also know this situation, why are they still willing to lend money and, indeed, as much as possible? Although explained in part above, EM8 provided more details to supplement this general statement about accepting the existing situation:

"We are all doing business and making a profit. They (banks) are also enterprises, and also doing business. (EM8: Transcript 16, P.6)

As indicated from EM8's quotes, **profit making** may be part of the answer. EM10 makes it much clearer,

> "Banks are also doing business and they are 'selling' loans, it (the loan amount) is like their sales amount; they also require good sales performance." (EM10: Transcript 18, P.6)

So banks can earn more money (in the form of interest) if they lend out more loans. The cynicism about the role of banks goes further, as can be seen from the conversation with EM10,

> "[…] on the premise that your comprehensive condition is good, they will maximise your loan amount." (EM10: Transcript 18, P.6)

EM10's opinion about the image of banks is same as that of EM8 and other interviewees: he considers that the banks' main incentive, and consequently that of the loan manger, as the quote emphasises, is to provide loans. This could be attributed to competition between banks being currently fierce, and so they can only make more profit by finding more customers and making more loans. What does the "comprehensive condition is good" in the above quote mean? We can see a more specific explanation of it from EM2,

> "It is actually the same as us enterprises doing business; if your enterprise has good credit and always pays the bills on time, then of course I would like to do business with you. Banks are also like this nowadays. If your enterprise has good profitability, credit and collateral, they will come to you and ask you to take out the loan. […] otherwise, they will ignore you." (EM2 and EM3: Transcript 11, P.1)

Provided the macroeconomic condition is good, which means the enterprise can operate normally and make profits sustainably, then banks like to lend as much as they can. This is likely to be due also to the risk of the loan being lower if the enterprise has strong profitability, credit, collateral, and so on. It is apparent that EM2 shares the

opinion of EM10, as he states that banks will even seek out good enterprises to propose loans to; they are very willing to make loans. EM10 explains in further detail how the banks maximised his loan:

> "I might only be able to repay a 0.5 million loan, but I actually got a 1.75 million CNY loan. […] The maximisation of my loan amount means that I could only have got a 0.5 million CNY loan according to my real circumstances, but they have lent me much more than that." (EM10: Transcript 18, P.6)

According to EM10's true circumstances (i.e. the total assets and annual sales of his enterprise), his repayment capability is only about 0.5 million CNY, which means he can only obtain that amount of loan theoretically (according to formal regulations or requirements of the bank), but nonetheless, the bank has lent him about 1.75 million CNY loan. EM10 also admitted in the interview that it was an initiative loan fraud; the extra amount of the loan was actually obtained by falsifying financial statements (overstating the financial indicators) and using false guarantors. And he even established a new company to guarantee himself, which is illegal according to formal rules. EM10 indicated that his LM knew about it and even helped him to do so, we would not discuss the legality of this case here. But it raises more specific questions: why would the bank or LMs lend to someone whom they know is exaggerating his repayment ability, and why would they ignore the risks?

Though it is answered partially in previous quotes, EM2 and EM4 explain in more detail why banks are willing to do so:

> "Banks make their livings through the differences in interest between deposits and loans; they need to make loans to survive." (EM4: Transcript 12, P.6)

> "Banks make profits through making loans. It is actually like us enterprises - if we are not able to sell our products but just produce, we will lose money. Banks also need to pay interest on deposits, so if they are not able to lend these 'deposits', they will also lose money, and thus they also hope to make loans, right? They eagerly look forward to lending money to good enterprises, since good enterprises

are able to repay the loans. " (EM2 and EM3: Transcript 11, P.5)

Here, we see that EM2 and EM4 impute particular motives for banks' actions. Both EM2 and EM4 consider that lending is a necessity for banks' survival; if banks do not make loans, then they are not able to make a profit and survive. They have to 'sell' loans and they are prepared to break their own rules in order to do so. This has several effects: firstly, it legitimizes the actions of SMEs. Secondly, it also calls into question other types of accounting system, such as the bank's accounting system, which will be discussed in detail in Chapter 8. In general, this incentive casts the SME manager as little more than a beneficiary of the bank's stupidity; however, the bank can also benefit from this 'stupidity', which results in some kind of balance. In addition, LM8 from a bank said,

> "To banks, financial statements are only for doing business; they are all false and not reliable." (LM8: Transcript 8, P.4, 12)

The above quote not only indicates that banks are aware of this situation, but also identifies the incentive for the bank side. That is, LMs also consider lending money to be a kind of business for banks, so this is not only SME managers' viewpoint. Related to business, EM6 also mentions the profitability of banks:

> "The interest on loans is too high nowadays in China; we are making money for banks actually. The interest rate in Hong Kong is only about 2%, but it is about 6% here" (EM6: Transcript 14, P.7)

The meaning of EM6's words here is that he thinks that most of an enterprise's earnings are used to pay the interest on loans (since the average annual earning rate for manufacturing enterprises in China is only about 10%), so that they are almost making profits for banks rather than for themselves, which also shows that banks can earn quite a considerable amount from lending. This implies that there is an incentive for banks to do business indirectly.

Apart from banks, LMs can also benefit from lending since they can receive commission from each lending transaction they make, which is another considerable incentive on the bank side:

"Their wages and bonus are also related to it." (EM10: Transcript 18, P.6)

EM10's statement here means that banks have a performance evaluation system for their LMs. EM2 clarifies this:

"Nowadays, all the banks, including loan managers, they all have performance (evaluations) actually. If you can keep previous customers and bring in more, this is your performance. I find it that loan managers from banks are just like salesman from companies, in fact, they are quite similar; they are all people doing marketing jobs." (EM2 and EM3: Transcript 11, P.8)

EM2 considers that the performance evaluation system in banks makes LMs become salesmen, since their salaries depend on how many lending transactions they carry out. This is corresponding exactly to what EM4 said:

"Banks have a marketing model, […] which is mainly based on their incentive policies. […] You (LMs) need to do marketing, to sell, and loan lending also depends on marketing. […] And there are returns (for LMs) from it, like bonuses, commissions and so on." (EM4: Transcript 12, P.6)

EM4 also points out here that banks are just like commercial companies, who use incentive policies to incentivise their employees to 'sell' more loans. At the same time, it is also indicated here that LMs could benefits from lending, as EM10 stated previously. The performance evaluation system might be positive for the operation of banks, and LMs could also benefit from it. However, apart from the returns, it might not be as beneficial as it looks to loan managers, LM8 complained about this system from another perspective:

"There is no other way; we are all under great pressure because of the performance

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evaluation, especially in JSCBs. So in order to get the business done, you have to take the risk. If your performance is good, then you do not need to take the risk, right? But if not, if you cannot even earn enough money to buy meals, then there is no other way but take the risk. You have to try even if you know that enterprise is near bankruptcy. Because in that situation, you will think that the enterprise may still have the chance to survive if you are lucky enough. And despite the high risk of a bad loan, there is still the possibility of success if you try, right?" (LM8: Transcript 8, P.9)

In the above quote, when LM8 said a loan manager could not earn enough money to buy meals, he did not really mean he would suffer from starvation, but used this as a metaphor to show how bad the situation would be if he could not make loans and earn profit from them. This enhanced his incentive to take risks to release loans to unqualified enterprises. LM8 considers LMs to be speculators under performance evaluation pressures since they do not have any other choice. EM7 also shares similar opinions:

"[…] In order to achieve a certain amount of sales, loan managers from banks will help you to succeed (in getting loans); […] they can get commissions and banks can also earn high incomes from it. Some of the loan managers rely mainly on commissions for their incomes." (EM7: Transcript 15, P.5)

Just as other SME managers said previously, EM7 also considers that the purpose of banks or loans managers is to make more profit and earn more income. He also gives a detailed example to explain how much LMs can earn from lending:

"For example, if you have made a loan which is worth two hundred million CNY to an enterprise, then you can get at least two or three hundred thousand Yuan [commission] from it, or even up to four or five hundred thousand." (EM7: Transcript 15, P.5)

Earing more income is probably a very significant reason and incentive for so many LMs trying to make as many loans as they can, even though the risk may be very high.

Support regarding the impact of commissions on lending also comes from the borrowers' side:

> **Me:** *Is there any situation like this, also as you said just now, since loan managers or customer managers from banks get commission, is it possible that in order to get more commission, they will try to lend you more?*
>
> **EM7:** As a person, or as a rational person, of course the more the better. More (lending) means the loan manager's performance is better, and when his performance is better, his income will also be higher. […] He will help you to get this thing done. (EM7: Transcript 15, P.10)

So, as indicated from the above conversation and previous quotes, as long as an enterprise can fulfil (even if only after falsification) the minimum requirement of the official bank criteria, banks are willing to make as many loans as they can, since they can make more profit by doing so. However, when banks seek profits, and LMs also try to 'sell' as many loans as they can, many problems can arise, including the emergence and acquiescence of fraudulent financial statements. LMs may take risks to help falsify financial statements when SMEs are not able to fulfil the requirements of the official criteria, as they can also earn more salaries from it since their performance is better.

Continuing from the conversation above, in order to find out how LMs would help enterprises to obtain loans, I immediately asked EM7 the following question:

> **Me:** *Is it possible for him (loan manager) to help with 'window dressing' your statements?*
>
> **EM7:** You should not disclose this so obviously. […] you cannot simply say that these loan managers are just concerned with their own interests; this situation does arise, but it is on condition that your enterprise is truly good. Then he will help you and banks also like it. (EM7: Transcript 15, P.11)

EM7's response is quite interesting here; he warned me that I should not say this (the LM helps with 'window dressing') directly, even though I used a relatively mild word, 'window dressing', instead of 'falsify'. His standpoint is also very interesting, as

it appears that he, as a SME manager, is speaking positively about LMs. This will be discussed in later chapters. His reaction at least showed that he understood what I meant by asking the question. At the same time, he admitted that this phenomenon did occur. EM7's reaction here is also embedded in Chinese culture, as Chinese people would like you to guess, infer and understand them tacitly, rather than ask and say something directly, particularly when talking about sensitive issues. This "indirectness" characteristic is also reflected in other aspects of SME lending, which will be discussed in the discussion chapter (Chapter 8). Hence, it can be seen from the above quote that some LMs do help enterprises 'window dress' or falsify their statements, and EM7 also indicated that banks supported this behaviour. EM7's words here correspond exactly to what EM4 said in the interview, that is, that the mutual interest of lenders and borrowers is expressed in the fact that LMs assist enterprises in 'window dressing' their statements:

> **Me:** *So what is the exact situation about banks encouraging enterprises to make false statements, as you mentioned just now?*
> **EM4:** It is related to a bank policy, the one called performance evaluation, for example; you have to make at certain amount of loans every month. As a loan manager, if you are not able to make any loans, this means you cannot reach the bank's requirement, and then not only is your own income not guaranteed, but your career promotion in this bank will also be affected. Then [in this situation] if you are also getting along well with the enterprise, you may involve your own personal feelings in the [lending] transaction, and [help] make false financial statements.
> **Me:** *So the loan manager helps you make them [financial statements] look better?*
> **EM4:** Yes, loan managers will help make them look better and then submit them to the credit review meeting. This is a common phenomenon, very common. (EM4: Transcript 12, P.5)

Hence, the stress of the performance evaluation system in banks, which could have negative effects on income and career development is thought by EM4 to be the incentive for LMs being willing to cooperate with the SME managers to make false financial statements, accept them and finally help the managers get the loan. In addition, EM4 also pointed out that a good relationship with SMEs is also an incentive, which

will be discussed in terms of *guanxi* in later chapters. This situation mentioned by EM4 here is the same as EM10's situation, analysed previously, where he also obtained 'help' from his LM. In conclusion, it has been discussed in many previous studies there are many reasons why FSF happens (Bell and Carcello, 2000), three main incentives for forming the fraudulent accounting environment are revealed in this section. On the bank side, these are the profit-making incentive and the performance evaluation system, followed by LMs' consideration about their incomes (i.e. commission) and further career development. On the SME side, the incentive is simpler. Since SMEs are not able to obtain adequate funding from traditional financial institutions, so the need for financing is one important reason why the number of fraudulent financial statements has been increasing (Rezaee, 2005). And it is also shown in this chapter that it is a considerable incentive for SMEs to provide false financial statements to banks. Generally speaking, these incentives are all interest-oriented, to enhance SMEs', banks' or LMs' interests.

In addition to profit making, safety is another element that banks will consider when making a loan. Normally, banks set up formal rules and requirements to ensure the safety of their lending, but these strict rules also frame the falsification of statements, as EM 10 explained:

> "There are strict, formal rules in the bank; they will look at your assets and annual sales. For example, if you have 10 million annual sales, then you can only get a 3 million loan, maximum." (EM10: Transcript 18, P.10)

EM10's words mirror what LM9 stated in the interview,

> "The loan amount will not exceed 30% of the annual sales; for example, if you have annual sales of 10 million, you can only apply for a 3 million loan at most, and we may only lend you 2 to 2.5 million in the end" (LM9: Transcript 9, P.15)

He gave an example later in the interview to explain their motivation and how they conduct the accounting falsification:

"If you only have 5 million annual sales but want a 3 million loan, then you have to falsify the annual sales to 10 million CNY (on the financial statements). If you need a loan of less than 2 million, then you may only need to falsify the annual sales to 6 million. So, this is the situation, and this is also why I am saying that all my financial statements are false." (EM10: Transcript 18, P.11)

From the above quotes, it can be seen that there is an interesting tension: on the one hand, in order to reduce risks, there are strict formal rules or official criteria (such as credit scores and '5Cs'[12], i.e. you can obtain a loan of a certain amount only if your annual sales reach a certain amount) in the bank which impose requirements on their customers. On the other hand, banks and LMs know that the very same rules are circumvented through the preparation of falsified financial statements. Since cash-starved SMEs cannot meet the banks' formal requirements, which are necessary for approving the loans, SME managers prepare false statements in order to fulfil the requirements and banks also accept them. Hence, such strict, formal rules may also be part of the reason and incentive for there being so much false accounting information among Chinese SMEs. If the formal rules were less strict for SMEs, i.e. if the annual sales requirement was lower, then SMEs might not need to falsify their annual sales on the statements. Therefore, to some extent, SMEs are forced to provide false accounting information, since they are not able to obtain adequate funding if they do not do so. EM10 continued:

"I only needed about a 1.2 million loan (to develop the enterprise) actually, but they lent me 1.75 million, which means I got about 0.55 million extra. And I have no idea about where I have spent the money now." (EM10: Transcript 18, P.6)

As EM10 mentioned in the previous quote and here, he can only get 0.5 million

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[12] The '5Cs' refer to the character, capital, capacity, collateral, and cycle. Character mainly refers to the applicant's credit records, the capital is the leverage or liability of the enterprise, the capacity is about the liquidity or cash flow of the enterprise, the collateral is in form of fixed assets or guarantees. The cycle refers to the macro-economic cycle (Yeung, 2009: 290). Since this research is not about formal criteria, it is not discussed in detail here. More details can be found in Yeung's (2009) paper.

according to the bank rules, but his funding demand was 1.2 million. According to the formal rules, he would not be able to obtain sufficient funding through normal procedures. However, after the falsification (i.e. falsifying and overstating the annual sales on the financial statements), EM10 obtained a bigger loan than he ever expected or indeed, needed. However, the interesting point in this case is that the bank actually lent him much more money than he actually needed, although this corresponds to the incentive of banks, as explained before, which is the maximising of profit. Banks want to make more profit by lending out more money. In general, it can be concluded here that not only did EM10 from the SME need a bigger loan, but also, for its part, the bank would like to provide as much as it could, or even more than the SMEs' needs. However, such behaviour is also risky if the bank lends more than the enterprise can afford:

> "I only have 0.5 million repayment capability, but you lend me 1.75 million. If my enterprise operates well, I may be able to repay this 1.75 million slowly and gradually. However, under the circumstances that the macroeconomic conditions are bad and my business is not good either, the risk is higher; it may accelerate my enterprise's bankruptcy." (EM10: Transcript 18, P.6)

As indicated from the above quote, when the bank lends more funds than the enterprise truly needs, this is also a burden on the enterprise since it needs to pay more interest, which would affect the enterprise's subsequent profitability and thus ultimately affect further development. In addition, there is also the question of the risk of the loan. As EM10 said, he was not quite sure if he could repay the loan or not, because it greatly exceeded his true repaying capability. During the interview, EM10 also said he just used up all the loan but that it was not spent entirely on the enterprise's development (with some of it going on, for example, buying luxury goods), which also increased the risks. However, I had the impression in the interview that EM10 was conscientious about the repayment. Moreover, as his enterprise was on the right track and operating well, he was gradually reducing the loan. He stated that he would try to repay part of the loan whenever he had extra money and so reduce the amount. Nonetheless, it appears that the risk remains quite high here; it is to be hoped that the macroeconomic conditions remain good and that EM10's enterprise continues to operate well; otherwise, he will

not be able to repay the loan and the bank will not receive the full amount back. Thus, it appears that sometimes, banks care more about profits rather than risk, and the interest-oriented incentive is sufficiently strong to make banks and LMs ignore the risks.

4.4. Summary

This chapter makes two main contributions. First, it explores the current accounting situations of SMEs in China, and reveals that financial information is not what Chinese financial institutions' main concern when making loans. Second, the empirical research findings in section 4.3 show that it is not only the borrowers (SME managers) who decide to falsify their accounts (as shown in section 4.2), but that there is an entire system of incentives that motivates all the participants to falsify information and accept false information.

In this chapter, the interviewees (both LMs and SME managers) spoke of the inaccuracy and invalidity of accounting information in China, and the findings show there are two apparent causes of this environment: the difficulty in tracking cash flows validly and the limitations of the rights of banks and LMs. The analysis indicates that the root cause of this environment might be the imperfect system of accounting management and supervision in China, which will be discussed in Chapter8. The findings show that, for no matter what reason, the tracking of cash flows is always a considerable problem for Chinese LMs, and that this problem can lead to some 'missing' accounting information. Chinese LMs are not able to get all the information they want because of the inadequate supervision of cash flows. In addition, it is very difficult for financial institutions to track cash flows that go through SME managers' personal accounts, resulting in the inaccuracy of Chinese SMEs' accounting information. Furthermore, LMs and banks do not have the legal right to require SMEs to provide formal financial statements, which causes the problem of information asymmetry and gives SME managers the opportunity to provide false statements. This is also the root cause of LMs' use of other methods than financial statements to investigate SMEs, since their right to obtain valid information from these statements is limited, as will be presented in the next chapter.

It is also confirmed in this chapter that both parties are clearly aware of the environment; that is, they know that financial statements are not reliable, but still accept them. The findings show that there are three main incentives for their doing so: the profit-making incentive, the performance evaluation system and overly stringent formal rules. The performance evaluation system in banks motivates LMs to consider their own interests (i.e., commissions and career development). The more loans LMs make, the better their performances, and the higher the more salaries they can obtain. Therefore, in order to earn more income for themselves, some LMs may do their utmost to help enterprises to obtain loans successfully, by helping SMEs make false financial statements and passing them to the credit review department. And even lend more funds than the enterprise expect, which is also a burden on the enterprise since it has to pay more interests. The profit-making incentive motivates banks to make as many loans as they can, since they can earn more profit by doing so. This leads to their ignoring risks to some extent, by accepting invalid and inaccurate financial statements. If they do not do so, the banks may not be able to survive. From the SME perspective, the overly stringent formal rules of traditional financial institutions make it difficult to obtain adequate funds from them, which, as shown in this chapter, gives SMEs a considerable incentive to provide false financial statements to banks; otherwise, they would not qualify for the loans. Hence, it can be inferred that these incentives are all interest-driven. That is, it is in the banks' and LMs' interests to make more profit, and in the SMEs' interest to achieve their funding objectives.

Following this presentation of the findings, the paper offers initial insights into the implications of this situation for theories of financial reporting and for practitioners. This chapter is also the starting point for the research, as well as the most important motivation for the researcher to conduct this research. That is, if everyone followed the rules strictly, meaning SME managers provided true financial reports and LMs did not accept false financial reports, or if the lending requirements are not that high, there would then be no necessity for the existence of *guanxi* or other non-financial investigation methods in the lending process. Since financial reports are invalid and inaccurate, which means they are not trustworthy, *guanxi* and other methods are used to investigate and provide more reliable information on enterprises' true financial

situation. If we are then to accept that accounting information is untrustworthy, and, given that financial statements are not reliable, and the accounting environment is poor, then how do Chinese financial institutions such as banks conduct evaluations of Chinese SMEs in order to make lending decisions? The following chapter will attempt to answer this question.

Chapter Five: Practices of loan information collection, evaluation and approval

5.1 Introduction

It was revealed in the last chapter that the level of trust in accounting information, such as financial statements, is very low in China. It is not only borrowers who decide to falsify their accounts, but there is an entire system of incentives that motivates participants to falsify information and accept it. In this light, it is important to study the loan decision-making of Chinese financial institutions, since they are completely different from recognised Western banking practices that place greater reliance on accounting information. In many other countries, accounting information is usually trustable and loan managers can make a lending decision according only to the financial statements provided by enterprises. However, the situation is different in China; as indicated by the research data, non-financial information is used to reflect something, but what role does it play in the lending process?

Yeung (2009) explains clearly how SOCBs use financial and formal criteria (i.e. credit scores and '5Cs') to investigate enterprises and examines how loans are granted by SOCBs to manufacturing firms in China. However, as he suggests that informal criteria deserve further investigation, so this present research also seeks to explore more informal criteria (i.e. non-financial information such as the SME manager's personality) that could affect the lending decision making. Following the findings thus far, this chapter aims to provide an answer to the following question: what happens when accounting information such as financial statements is not able to reflect the true situations? Or to be more specific, if there is such distrust in financial information, then how do financial institutions conduct loan evaluation and approval for Chinese SMEs based on non-financial information? There are two main sections in this chapter: section 5.2 shows that some non-financial information is widely collected by financial institutions to reflect true conditions of SMEs in China. It also presents how loan managers (LMs) analyse and evaluate SMEs based on the non-financial information they collect. Section 5.3 explains how Chinese financial institutions make lending

decision based on the information (mostly non-financial) they obtain.

5.2 Non-financial information collection and evaluation

Financial information such as ratios like annual sales and turnover are very important in showing a company's health, but due to the untrustworthiness of financial information in China, verification of the truth of these ratios is a great challenge. Brazel *et al.* (2005) find that non-financial information can be effectively used to identify fraud during analytical procedures, since it is harder to manipulate non-financial information than financial statements. Behn and Riley (1999) present empirical research findings that showing non-financial information can be used to predict financial performance in the airline industry; it is useful in predicting financial ratios such as quarterly revenues, operating income and so on. Bernard and Noel (1991) show that one specific piece of non-financial information, inventory disclosures, can predict future sales and earnings. Therefore, in addition to financial ratio analysis, non-financial information also has the potential to allow evaluation of a firm's performance, which improves fraud detection (Hogan *et al.* 2008). After my fieldwork, I found that the investigation of SMEs' non-financial information is indeed even more important than financial information in reflecting the truth. As LM1 said, *"We mainly rely on non-financial factors [to investigate SMEs.]"* (LM1: Transcript 1a, P.1) As LM2 also said, *"It is because the financial [analysis or data] cannot reflect the true conditions of SMEs. Definitely, the true conditions of SMEs are all reflected in the non-financial information."* (LM2: Transcript 2, P.11) Hence, non-financial information is widely collected and used to investigate SMEs in China. So this section focuses mainly on the investigation of using unofficial criteria to collect non-financial information and evaluate SMEs. From the research data, it is found that there are two non-financial factors that frequently mentioned by interviewees to investigate SMEs, which are the conditions of SME manager and the 'production and operation condition' of the enterprise. So the following sub-sections want to analyse them in detail.

5.2.1 Information about the conditions of SME manager and analysis

The conditions of SME manager mainly refer to the personality or credit status of the actual controller of the lending enterprise, or his family status and so on. LM3 makes it clear what kind of information they will collect about SME managers:

> "All his personal information, including his ID card, permanent residence registration book, marriage certificate, home address, his background, his capital condition and so on. Other information such as whether he has been sued by court or not, and whether the industrial and commercial bureau has received any complaints about his enterprise; we will investigate all these kinds of thing." (LM3: Transcript 3, P.5)

We can see from the quote that the information mentioned above is very private information, which gives a complete picture of the SME manager's background. I know it is not only LM3 but also other LMs who request information like this from their SME manager customers.

The personality or credit refers to whether the SME manager is honest and has integrity for example. The risk of making a loan to a person of integrity is definitely lower than lending to a deceitful one, since the former is basically moral, and will always think about repaying the loan, while the latter one may not. Furthermore, the SME manager plays an important role in the SME, and in China, investigating the enterprise is sometimes identical to investigating the SME manager, *"since he has the power of life and death over the enterprise."* (LM3: Transcript 3, P.10) Hence, it is very important to know what the SME manager is like, what he wants to do and what his plans are for the future development of the enterprise. LM2 said he would chat with the controller of the enterprise to get more information:

> "[…] we will have a meeting with the actual controller, in order to know his management thoughts and capability. Including his investment diversification methods, risk management and so on." (LM2: Transcript 2, P.2)

The actual controller of the enterprise means someone who is actually in charge of the company, he or she might be the nominal manager of the enterprise, or might not. Because for example, it is also a widely seen phenomenon in China that a couple owns the small enterprise, the legal representative of the firm is the wife, which means she is the nominal enterprise manager. However, the fact is that her husband is the one who actually operates and controls the firm, and who is the 'actual controller' there. It is very important to investigate the actually controller since he is the one who could truly decide the destiny of the enterprise. So LMs will chat with the actual controller of the enterprise and try their best to find out if he or she is a capable manager or not, and to discover if the enterprise will go well under his or her control. If the LM considers that the actual controller is not a proper manager after the interaction with him, then the risk of lending is high, and they may not make the loan. As LM3 mentioned,

> "The company has limited liability, so with the 'debt escaping or denying' problem we talked about just now, no matter how much you want to investigate and affix his legal liability, he can just give you the whole company and there are not many assets left, actually. His assets must be less than his liabilities, and that is why he goes bankrupt. So the credit of the SME manager is very important." (LM3: Transcript 3, P.5)

Before this statement, LM3 explained the "debt escaping or denying" (*taofeizhai,* 逃废债) problem in the interview. It means that the SME manager is still able to repay part or all of the debts, but as he has a dishonest personality is very bad, he just declares bankruptcy, leaves the bankrupt and asset-less enterprise to the debt holders and 'runs away' from it. Therefore, as can be seen here, the "debt escaping or denying" (*taofeizhai*) problem is a kind of default behavior on the part of the SME manager due to his dishonest personality, which is a widespread phenomenon in China recently, particularly in the last few years. As both LM3 and EM4 said in the interview, the escaping SME manager could even set up a new enterprise just beside the old one, because of the limited liability. He could ask other people to register a new company for him but he would still control the new enterprise. Superficially, the new enterprise would be completely new one, with a different name and another person as its legal

representative. The name of the manager of the old SME manager's name will not even be on the list of stockholders or any other formal document of the enterprise, but he is still the one who actually controls the enterprise. Hence, it seems that the new enterprise has nothing to do with the SME manager, but he is still its 'actual controller'. The SME manager can escape all his previous debts in this way and just leave all the debts to financial institutions such as banks, and the banks can do nothing about it. This is also the reason why LM2 introduced the concept of 'actual controller' to me previously, because in China, the nominal SME manager may not be the one who really operates the enterprise, so the LM needs to talk to the person who actually controls the enterprise in order to investigate.

LM8 also mentioned the relationship between the "debt escaping or denying" (*taofeizhai*) problem and an SME manager's personality in the interview:

> "Personality is very important. When the macroeconomic situation was not good and many enterprises went bankrupt, there were a lot of enterprises that struggled through it actually, but some SME managers with bad personalities, they just left their enterprises to go bankrupt, since they wanted to run away from the debts. They transferred all the assets and let their enterprises go bankrupt in this way." (LM8: Transcript 8, P.8)

LM8 mentioned "assets transfer" here, which is similar what LM3 said in the interview, that some bad SME managers may even transfer previous assets (e.g. equipment) secretly from the old enterprises (before their bankruptcy) to the new ones, which causes more losses for the creditors. However, if the SME manager's personality is good, he may continue the business and repay the loans gradually, and the debt holders may bear less loses even when bad loans happen, since he has bottom lines. This is why SME managers' personality is very important. Hence, it can be seen that information about the actual controller's personality is very important.

Apart from the SME manager's personality and his reputation in the market, LM5

considers the SME manager's family status as another important piece of non-financial information that he will check before the lending.

> "We will also check his family, to see if it is normal. For example, we have got a customer who is about forty years old but still single; he has never been married. We think it is very strange in China; there must be some reasons, right? [...] We will consider normal families first; there is no problem about normal families, we only need to see the quality of their relationship; if his spouse also would like to sign the lending contract, then it means there is no problem. But the customer who is about forty years old but still single, I think there is something wrong with him; he may have psychological problems." (LM5: Transcript 5, P.25)

LM5 takes one of his customers as an example to explain why a SME manager's family status is important. The customer is about forty years old but has never been married, which may be common in Western countries, but is very rare in China; there is a cultural difference here. In China, people always treat family importantly and people usually get married before the age of thirty, and as the very famous Chinese philosopher Confucius said, "Set up your family first, and then start your career." This also shows the importance of marriage and family in China. This is why LM5 would consider this customer to have 'problems'. LM5 voiced his suspicion with these words,

> "This customer is extremely arrogant and it is difficult to get along with him. For example, when we asked him to pay the interest, he replied, 'I will pay you before twelve o'clock, what are you worrying about?' What could I say? When the loan was due, he spoke to you like this, 'I want to renew the loan, you must handle it.' The meaning of his words is that we must renew his loan; otherwise, he will not repay the loan. So how can we reply to him when the loan is still not repaid yet? He is definitely abnormal, sociopathic, right? This kind of people usually have psychological problems. People with normal families and children do not have this kind of problem." (LM5: Transcript 5, P.26)

Further interactions with the customer proved his suspicion to be well-founded, as LM5 found that this customer was extremely arrogant and very difficult to get along

with, which may have been be the reason the customer was still single, as no-one would want to marry him. Based on his experience, I think LM5 is using reverse thinking here: the assumption is that if a customer is fine, then there should be someone who would like to marry him, while if the customer does not have any experience of marriage at that age (as a Chinese), then there might something wrong with him. This is, of course, not necessarily the case, as there are a number of valid reasons for remaining unmarried, such as not having found the right marriage partner, but in Chinese culture, it is seen as an indication that there is something suspect about the person. This explains why LM5 prefers to lend loans to those with 'normal' families, and will be careful of those without a family. Maybe this is an extreme and single case here, and it was observed during the interview that LM5 did not like this customer since he used very strong tones. But it still reflects something about Chinese SME lending, which is different from the Western model. In China, your private or personal life is not separate from your business operation, but part of it, they are usually seen as two parts of one whole. In addition, people, whether business partners or LMs in this case, will scrutinise your family life as well, which is a cultural tradition.

The true purpose for which the SME manager needs the loan is another important piece of non-financial information that LM3 will collect during the lending investigation,

> "Will he use the loan to invest in new projects? Or just for consumption, like buying a car? We need to check his true purpose for the loan." (LM3: Transcript 3, P.5, 6)

The true purpose of the loan refers to how the SME manager will use the loan, which is also related to the SME manager. If the loan is not used on the development of the enterprise, but on other things like buying a new car, then it means the loan is not making profits, so that the risk of not being able to pay back the loan is high. This is why LM3 wants to check the purpose of the loan. LM5 has explained a little bit about how to check the purpose of the loan in the interview:

> "… I will also try to find out if the SME manager is interested in his main business.

If he is not interested in it, he is not serious in doing this business, then it means that he can make more money from other businesses, he does not care about this one. This means he has invested the loan into other projects, but not his main business. This is the worst thing we are afraid of." (LM5: Transcript 5, P.7)

We can see from the above quote that LM5 cares a great deal about the loan purpose, and he uses the words "worst thing" and "afraid of" in the last sentence of the above quote, which also shows how seriously he treats this information. Although LM5 has not explained why the "SME manager does not invest the loan in his main business" is the worst thing he is afraid of, I think the reason may be the same as the one LM3 gave; it is also about the risk. Perhaps LM5 is not able to control the risk if the SME manager does not invest the loan on his main business. LM3 gives an example to explain how to analyse this information and make the lending decision,

"For example, if an enterprise wants to buy new manufacturing equipment that is worth one million CNY, then we may only lend the enterprise seven hundred thousand CNY, […] and there must be a contract and invoice for buying the equipment. Then we will check the contract and relevant invoice, [we will check] if the price of the equipment is real or not. Based on the fact that he is really buying the equipment to produce products, we will make the loan, since after selling the products produced, he can repay our loan by the profits made." (LM3: Transcript 3, P.7)

In the example above, due to the suspicion that the enterprise manager may not invest the entire loan in purchasing the equipment, but in other places. Or, LM3 may ask himself, what if the SME manager overstates the equipment price just in order to get more loans? So he wants to check the contract and invoice of buying equipment to identify the loan purpose. If the loan is not used to buy new equipment, then no products will be produced and LM3 will not be able to control the risk, because it is uncertain whether the SME manager can make any profit from the loan, and it is hard to discover what the loan will be used for. As LM1 said,

"Some people just use up all the loan buying things but do not want to repay it."

(LM1: Transcript 1a, P.1)

As LM1, LM3 and other loan managers mentioned in the interview, it is a common phenomenon in China that some SME managers just use a loan for consumption, such as for buying new cars or luxury goods, but not for the development of their enterprises. Therefore, in order to identify that the enterprise has really bought the equipment and the price is the same as the one given when applying for the loan, LM3 will check the equipment buying transaction contract and invoice to verify it. As discussed previously, the reason LM3 cares so much about the real loan purpose is because of the risks. If the loan is used on the original purpose, then the probability of loan repayment is high and the safety is ensured. Meanwhile, it is also very common in China for SME managers to have no concept about the repayment of a loan; they just think it is their own money and use it up. Thus, in addition to loan purpose, repayment ability and willingness are two other very important non-financial factors.

During the interview, LM4 showed me a booklet which introduces all the non-financial factors that will affect the final lending decision. According to the booklet, **the repayment ability** determines whether an enterprise or a SME manager is able to repay the loan or not, and, as LM4 also said,

> "Take an extreme example, even if a customer (SME manager) cannot repay the loans but his borrowing power is good enough, this means he just needs to make a phone call and his relatives or friends will send the money to us. Then we will still consider making him the loan, since the risk is low." (LM4: Pilot interview transcript 4b, P.7)

'Borrowing power' is a kind of repayment ability, which shows the borrower's ability to raise money in a very short time. I think it is all about risks here; if there is someone who can help to repay the loan when the borrower is not able to, then the risk is low and LM4 is willing to cooperate. Although LM4 did not mention how to measure or investigate repayment ability in detail, I infer from the interview that it may be in the form of a guarantee. The bank may ask the SME manager to find a guarantor to

guarantee the loan. Or, as LM4 released in the interview, it is not even necessary to have a specific guarantor; it is also fine as long as the LM knows that the borrower has relatives or friends who would repay the loan. On the one hand, the borrowing power shows the ability to ask others to repay the loan for the borrower, while, on the other hand, it can also reflect the borrower's personality,

> "Borrowing power means […] at least there are some people who would lend you money [...] If your relatives or friends would lend you the money, this means that you are a good person (and they trust you); at least they know you better than we do." (LM4: Transcript 4a, P.19)

It is indicated here that the repayment ability can be reflected in the guarantee condition, the repayment ability is higher if the borrower has guarantors. It is also indicated from the data that borrowing power can be measured through a long-term interaction and understanding with the borrower (SME manager), but LMs have to obtain this kind of non-financial information by themselves. They need to know the borrower, his family or friend circle well, in order to know if there is someone who would repay the loan for the borrower. Which is about *guanxi* and will be discussed in the following chapters.

Repayment willingness refers to whether the SME manager would repay the loan, and repay it on time or not, which, indeed, is also related to the SME manager's personality. LM8 shared some opinions about his customers.

> "I think a SME manager's personality is more important than the enterprise's operating condition. I have met a lot of SME managers who are not able to sustain their enterprises, but they still try their best to repay the loan. While a lot of other SME managers, as I said just now, their enterprises are not near bankruptcy, but they will try their best to repudiate the debts. I have been in the bank for many years, and I have seen a lot of people like this. Especially nowadays when the macroeconomic condition is not good, there are many people like this." (LM8: Transcript 8, P.11)

LM8 is also talking about the "debt escaping or denying" (*taofeizhai*) problem here; the borrower's repayment willingness is greatly dependent on his awareness of credit and the law. If the SME manager has a good knowledge of these, then he will not try to avoid repaying the debt. Furthermore, if the borrower engages in any other behavior such as tax evasion, providing false statements to obtain loans or defaulting on the loans, then these behaviours also mean the borrower's legal awareness is low, and his morality is poor, meaning that he not be greatly willing to make the repayments.

Hence, as can be seen from this section, the conditions of SME manager involve the SME manager's personality, credit, his thoughts about the management and operation of the enterprise, his family situation and so on. In general, LMs are concerned with anything about the SME manager that could affect the operation of the enterprise and thus affect the loan repayment. Since it is SME managers who operate SMEs and they have the power of life and death over the enterprise, their personality or personal credit could directly determine the risk of the loan.

5.2.2 Information about SME's 'production and operation condition' and analysis
SME's 'production and operation condition' is present throughout the whole paper: if financial statements in China can reflect the true conditions of SMEs, then there is no need to use other non-financial methods to investigate enterprises. However, the fact is not the case, so how to discover enterprises' real condition is a considerable problem, and is also the purpose of this chapter.

LM3 uses water and electricity bills in his evaluation of SMEs, to see

"…if the enterprise operates and produces normally." (LM3: Transcript 3, P.8)

Since, in manufacturing SMEs, water and electricity are necessities in producing products, financial institutions in China use the bills of these two utilities to discover the condition of the SME. Another interviewee, LM2, also mentioned in the interview that the water and electricity usage of the enterprise can also reflect the prosperity degree of the enterprise, higher usage means greater prosperity. In the pilot-interview,

LM1 also talked about how they use water and electricity payment records to estimate the production value of SMEs in detail:

> "…Water and electricity expenses are observable. For example, we will consider their production value before lending. If the production value was 5 million RMB last year, and the entrepreneur says it is 8 million RMB this year, the increase is about 60 percent. Then we will check if their water and electricity payments have increased correspondingly. If the expenses have also increased significantly, this means the data is trustworthy, as records of water and electric payments cannot usually be faked." (LM1: Transcript 1b, P.3)

This excerpt explains the method of verifying the truth of production values: if the increases in water and electricity usage corresponds to the increase in the value of production value, this means the figure for the value of production is true. For example, when the production value has increased by sixty percent, if the water and electricity expenses have also increased by about sixty percent, then this means the reported increase in production value is reliable. The calculative logic here is that a rise in output should be reflected in a corresponding rise in input. Why? It is because inputs and outputs always correspond to each other; you cannot have outputs if you do not have the appropriate amount of inputs. In addition, as many other interviewees have mentioned in their interviews, records of water and electricity payments are always true since they are from third companies, and which utility companies are all state-owned in China, so it is very hard to make false records. Besides, it is also not very hard to obtain these records, and which makes this method more efficient. This is why water and electricity payments are widely used to evaluate SMEs' production values (outputs) in China. Although this method includes some numeric data, it is quite different from western investigation methods and could reflect something. So that is why I put this quote here. But still, I want to emphasize it here that this research does not want to say that all the financial information is useless, but the concern of this chapter is the role of non-financial information and 'qualitative' investigation methods in SME lending.

In Chapter 4, it was revealed that banks are actually in a vulnerable position due to the moral hazard problem and the asymmetric information they may be given, such as the limited right of LMs in obtaining statements and SME managers maximising their own interests by providing false financial statements. Therefore, obtaining more information from SMEs means that the information asymmetry problem could be reduced, and the default risk will also be lower for the banks. Going to enterprises on field and talking to people there could solve this problem for banks and LMs to some extent. As LM4 said,

> "Considering the operation of the enterprise, whether it is operating well or not? We can see it by walking around the enterprise, […] to check their inventories or to see their machines." (LM4: Pilot interview transcript 4b, P.4)

Nearly all the LMs mentioned that "walking around the enterprise" is a necessary part of investigating an enterprise; it is the most direct way to check the enterprise's true condition in the field. LM6 collects the following information by "walking around the enterprise",

> "We will check whether the production is normal in the workshop. How many employees are there in the enterprise? How about the equipment's condition? Inventory condition? We will check all this kind of things; otherwise, we will not feel safe making the loan." (LM6: Transcript 6, P.9)

Since most SMEs in this research are manufacturing SMEs, LMs would be concerned more with information such as operational condition of the machines or equipment or the inventory of the enterprise, since such non-financial information could directly reflect the production of the enterprise. LM2, who is from a joint-stock commercial bank, explains a little about how to investigate the production and operation condition, but LM3 gives a more detailed explanation of it:

> "Is it producing products all day long or just in the daytime? If it produces products all day long, that means the business is good. We will go to the reception room of the enterprise to ask things like, whether there are many trucks going in and out of

the enterprise every day. As a manufacturing enterprise, you need to purchase raw
materials and sell your products, so if you operate normally, there should be some
trucks going in and out. (LM3: Transcript 3, P.10)

Normally, production condition is measured by the figures (i.e. how many products
produced every year) on the statements, but in this case, it is partially measured by non-
financial information like "Are the machines running all day long?" or "the number of
trucks going in and out the enterprise?" In addition to LM3, LM7 also mentioned this
in the interview. He considers that if the machines inside the enterprise are running 24
hours a day, then this means the enterprise always has orders and needs to produce
products every day; that is, its production condition is good and its business is going
well. LM2 also mentioned in the interview that he would judge an enterprise's prospects
by observing the trucks; if there are many trucks delivering goods going in and out the
enterprise, then this indicates that the enterprise has many products to sell, meaning
production is high, and so the enterprise's prospects are good. The conversation with
LM3 continues,

> "…But if every time you go to the enterprise, it is very quiet there, the gatekeeper
> just sits in the reception room and has nothing to do, then there must be something
> wrong with the enterprise." (LM3: Transcript 3, P.8)

The logic of the investigation here is that, as a manufacturing enterprise, if your
business is good (with many orders), then you need many trucks to ship the goods.
Therefore, if LM3 cannot see many trucks in the enterprise on field, then he will
consider that the enterprise's business is not good and be more careful about lending
afterwards. In contrast to LM3, who pays greater attention to the number of trucks, LM7
also mentioned in the interview that he would check whether there were many goods on
the trucks. So 'the number of trucks' and 'the amount of goods in the trucks' are used
to reflect the enterprise's production and business condition. In addition, during the
interview, I found that LM3 did not make the judgment only from a one-day visit; for
example, if LM3 went to the enterprise three times randomly (not on the same day), and
the enterprise was quiet every time, then there must be something wrong with the

enterprise. Hence, this kind of information make loan managers like LM2, LM3 and LM7 feel safer to make the loan.

This picture shows the workshop of a manufacturing SME, the machines are used to produce bearings.

Furthermore, LM9 will also go to the warehouse to check the inventory there and obtain some non-financial information from warehouse keepers:

> "Since most of the warehouse keepers in China are old people, mostly old men. I will offer him a cigarette, make a cup of tea and chat with him first, such as asking him where he comes from or how his health is. Then I will ask some questions about the enterprise, like what the inventory status is, if there are many goods transported in and out frequently and so on. Sometimes, they may even let you have a look at the warehouse-recording book. If there are no goods transported out of the warehouse for more than two weeks, that means there must be something wrong with the enterprise." (LM9: Transcript 9, P.4)

The LM will not ask questions about the enterprise's condition directly, but start by talking with other irrelevant things, build up *guanxi* with the warehouse keeper first and then ask some questions about the enterprise's condition. In this way, he can obtain more non-financial information about the enterprise and thus he may also discover some

problems through this kind of *guanxi* activity. Otherwise, the warehouse keeper might have scruples about providing any useful information. So this is about *guanxi* here. The way of using *guanxi* to investigate SMEs especially the SME managers will be discussed in the next chapter (Chapter 6) in detail. Similarly, the sales situation is not measured by the figure on the income statements, but from inventory records of the warehouse:

> "You can check the inventory records, what time the goods go in and out of the warehouse? For example, if your products have been stored in the warehouse for more than 6 months, then there must be something wrong with your enterprise, right? You can judge in this way. (LM3: Transcript 3, P.20)

If the inventory records have been unchanged for a long time, then this means the enterprise is not able to sell its products, and sales are not good. On the contrary, if there are many records, this means the enterprise's sales are very good, it is doing good business, so it is safer to make the loan. Hence, this is how LM3 evaluates the enterprise, according to its environment.

LM2 considers that the condition of the workers, that is, whether they are working hard or not, can reflect the enterprise's condition.

> "If there are twenty workers there and they are all working hard, then it is normal. But if they are not working, they are just standing there and chatting with each other, then you must go and ask them what is wrong." (LM2: Transcript 2, P.13)

LM2 pays great attention to the work performance of the workers in the enterprise; he talks to the workers and ask them if there was something wrong if he saw they were not working. This is also a very useful way to obtain some information about the enterprise. However, in order to show that their business is good, it often happens SME managers say that they have to keep producing goods in order to fulfil their orders, as LM3 said:

"When we are investigating one enterprise, we will not just [collect information and then] judge from talking with the SME manager, because that Chinese SME managers normally will not say anything bad about their enterprises, they will only say that their enterprises are the best." (LM3: Transcript 3, P.8)

It is a characteristic of Chinese businessmen to show the positive side, but ignore the negative aspects, in order to show the strength of the enterprise and obtain the loan. And it is also possible for them to falsify the production condition during LMs' on-field investigation to prove this. They can ask the workers to look like they are working very hard only during the investigation day, to show that their business is good. In this case, LM4 can determine the truth by asking the workers. If there is a contradiction between a SME manager's words (i.e., they are always busy producing goods) and the workers' words (i.e., they do not have much work to do), LM4 said he would place more credence on the non-financial information collected from the workers since,

"Under normal circumstances, the workers will not lie. One of them might lie due to personal issues [such as he hates the enterprise or the SME manager], but if a lot of workers said the same thing, and as you said, and a lot of products were stored in the warehouse which exceeded the normal storage range, then there must be something wrong there." (LM4: Transcript 4a, P.5)

The standard practice therefore, is that LM4 listens not just to one worker but verifies the situation with many workers. According to LM4's consideration, the probability of all the workers speaking ill of the enterprise is very low; if that happens, then he should definitely doubt the enterprise. As can be seen from the above, talking to the workers can determine whether the SME manager is telling the truth or not, and allow the LM to ascertain the enterprise's true condition. This is a method that LMs would frequently use in evaluating SMEs. LM3 would also investigate SMEs in a similar way.

"For example, we will walk around the workshop and ask the workers questions about their salary condition, working condition and so on" (LM3: Transcript 3, P.8)

It was revealed from the interview that LM3 investigates and judges his customers through various ways, but he thinks that walking around the enterprise and talking to the workers is a subsidiary aspect of lending investigation. LM4 will also ask the workers questions like,

> "Are there any wage arrears? If the boss has not paid workers wages for a long time, there must be something wrong with the company." (LM4: Transcript 4b, P.3)

Wage arrears is a very serious problem for enterprises. At the same time, it seems like that the wage arrears phenomenon is also a piece of very serious and sensitive information to banks, it was revealed in Chapter 4 that LM4 could tolerate the customer's overstatement about annual sales but not the wage arrears, because,

> "If you have problem with the labour wage payments, which means there must be something seriously wrong with your enterprise, […] if you are not able to pay wages to workers, this means you may go bankrupt at any time; this is a very serious problem if it is true." (LM4: Transcript 4a, P.5, 6.)

In addition, in a previous time period, many workers in China tried to commit suicide just in order to get their salaries back, which caused a great social instability problem. Many television stations and newspapers reported this social phenomenon, particularly several years ago. Since then, the Chinese government has treated it as a very serious social problem and requests that enterprises should not default their employees' wages; paying wages on time is always the priority of enterprises. This is also the reason why loan managers such as LM4 regard it as important. In addition, as LM4 also mentioned in the interview, wage arrears can reflect the health of the enterprise. If an enterprise is not able to pay the workers' wages, then it means the enterprise lacks money, which is a very strong signal. Furthermore, if the enterprise always delays their wages, the workers will not like to stay in the enterprise and will turn to other enterprises. Then it will affect and threat the operating stability of the enterprise. Therefore, LMs can perceive some problems or find some clues of problems from this kind of information. Hence, the importance of SMEs paying wages without

fail and on time is reflected here, and, as LM4 has also mentioned in the interview, that if the wage arrears issue continues and the enterprise cannot provide more collateral, then they will no longer make the loan.

This picture shows the warehouse of a manufacturing SME

LM9 will even check the cars parking condition outside the enterprise to get to know the enterprise's condition:

"If there are a lot of new and nice cars parking outside the enterprise all day long, this means the condition of the enterprise must be very good. […] Because it shows that the profits of the enterprise are good, so that the employees are able to buy nice cars. If there are only 5 to 10 cars parked outside, it is not strange, the cars belong to the executives. But what if there are 50 cars and the enterprise only has 150 employees? This means one-third of the people in this enterprise are middle-class in China. Then the enterprise is stable and its profitability will not be bad." (LM9: Transcript 9, P.19)

This is a very interesting investigation and evaluation method, which may only be used by LMs in China and not in Western countries. The most interesting point here is

that LM9 is like a policeman making a criminal investigation; he will try to analyse all the non-financial information that is relevant to the enterprise and try to find out if the enterprise is in good condition or not. The cars parked outside the enterprise appear to have nothing to do with the lending, but from LM9's viewpoint, they give a strong signal that could be used to evaluate the SME's condition. Moreover, he also uses reverse thinking here: if the employees in the enterprise are rich, then this enterprise must be good, so the lending risk is low. Apart from the information collected, the information collecting 'technique' is also very important. In order to collect more valid information, LM9 talks about a 'tricky' way in which he investigates SMEs:

> "Taking myself as an extreme example, I do the investigating craftily; there are three conditions under which I will not go to investigate the enterprise: I will not go to the enterprise when the SME manager is there, I will not go when the accounting staff wants to take me around, and I will not go there on a scheduled date. I will go to the enterprise randomly to see if the enterprise is manufacturing products normally." (LM9: Transcript 9, P.3)

Hence, LM9 prefers to investigate the enterprise 'secretly' and 'randomly'. As because of this, SME managers are not able to prepare before the investigation (as discussed before), so the truth of information collected from a random investigation is higher than from a non-random one. In addition, as LM2 and many other loan managers also mentioned in Chapter 4, even an SME's work site could also be falsified, which means some SME managers might rent a place, pretend it is his factory and hire some people to pose as his workers to apply for the loan. Therefore, LM9 uses random and secret visiting to avoid this situation.

5.2.3 Analysis of other non-financial information

As LM1 mentioned in the interview, **"government intervention"** is a very important non-financial factor that can affect lending, but how does it work? As LM9 said,

> "People from the head office will communicate with many national departments. They will add government intentions into the policies. For example, if the

government wants to wash out some excess capacity industry enterprises, then we will not lend them loans anymore." (LM9: Transcript 9, P.16)

The lending requirements and credit policies are designed by top authorities of the bank, and the government has the right to regulate these policy designs officially, which means the government can affect bank lending at macro level. The government can determine the lending direction by intervening in bank policies, which could result in, for example, this:

"We are tightening up our loans now; the bad enterprises are less likely to get loans from us, so there will be a lot of enterprises, especially SMEs, going bankrupt in the near future. This is also the government's intention actually, and is called the industrial adjustment; the government wants to wash out the bad enterprises, especially those from excess capacity industries. We banks are implementing the government policy, but when all these [bad] enterprises go bankrupt, it is us who are carrying the debts, actually." (LM9: Transcript 9, P.11, 12)

LM9 is from a state-owned bank, and the purpose of state-owned banks is not just to make a profit; they also have to obey the government. If the government wants to reduce SMEs in certain industries, then the government could require banks to cut or reduce their loans, and banks have to follow this order. Thus, by announcing policies and command banks, the government can decide which industry enterprises should be given more loans or which should eventually be wiped out. With these government interventions, financial institutions, particularly state-owned banks also have other purposes such as stabilising the national economy, maintaining society's stability (e.g. decreasing the unemployment rate), which could lead to other problems such as the implementation of informal rules, as will be discussed in later chapters.

After all the interviews, it was found that factors such as the **"the macroeconomic condition or industrial situation"** and **"guarantee condition"** were also frequently mentioned by other LMs in their interviews, not only by LM1. This means these two factors are also commonly used in the lending investigation in China. For example,

LM4 mentioned that "the macro-economic situation of the whole country or the industry's condition" is a very important factor that will affect lending, and the reason for this is because,

> "It is simple. When the situation is good and enterprises make profits, then it is safe for us to do business with them. But if the situation is bad, many enterprises are trapped, just like the stone market and lumber market near our bank. Since the industry situation is not good, so many tenants' assets are trapped there (maybe most of their assets are invested in the raw materials). So we would rather not to do business with them, which is better than be trapped together with them. Maybe the customer is fine now, but we are not sure if he will have problems in the near future or not, because the situation in the whole industry is not good. So, it is safer for us to keep our money." (LM4: Transcript 4a, P.9)

Here, LM4 gives a very good example about how "the macro-economic situation" affects SME lending, since the Chinese government wants to control the real estate market, and so fewer buildings will be built in the near future, meaning such that less stone and timber will be sold and used, resulting in the low price of construction materials which finally affects the borrowers' profitability. If the condition of the whole industry's condition is good, then it means that SMEs within the industry are able to make good profits and have steady development, so the risk of a bad loan is lower. According to LM4, when the situation in the whole industry is bad, and if the enterprise's industry is now a high-risk one and being blocked by banks, then he will be more careful about lending. The macroeconomic condition here also includes the Juglar or business cycle. There are four phases of one business circle: expansion, recession, depression and recovery (Schumpeter, 1939; Grinin, 2010). For example, if the whole industry is in a recession period, then the risk of bad loans is higher. Therefore, the industry the target SMEs belongs to is also very important, as LMs and financial institutions will be more cautious about their loans when the industry is in a recession or depression period. This does not only apply to the industry; another loan manager, LM3, considers that **the life cycles of enterprises** are also very important,

> "We will judge this customer's subsequent development potential, and his

development prospects. […] It is mainly about the judgment of the enterprise's prospects, what stage is the enterprise at? There are four stages, start-up stage, growth stage, maturation stage and recession stage. We will not get involved in the start-up stage, but we will do the growth and maturation stage. We will try our best to avoid any lending if the enterprise is in the recession stage; even if the SME manager is an acquaintance, we will avoid it as far as we can. This is the judgment of enterprises." (LM3: Transcript 3, P.11, 12)

If the enterprise is at the start-up or recession stage, then the risk of not being able to repay the loan is higher than at the other two stages, so I think this is the reason why LM3 only wishes to make loans to enterprises that are at the growth and maturation stages. Although LM3 did not mention how they estimate which stage the enterprise is at, I think it is probably through the sales volume, productivity or capital scale of the enterprise; for example, if the sales are increasing gradually and the enterprise is recruiting more workers, this means the enterprise is at the growth stage. I think LM3 can estimate it through these things, but in any case, it is still the LM who judges the enterprise by himself. In addition to the above factors, there are also several other non-financial factors in the booklet provided by LM4. However, as LM4 mentioned in the interview, it is not necessary for LMs to collect all the information and check all the non-financial factors in the booklet in practice; they only need to choose different factors according to different customers, since they could save time and energy by doing so. Therefore, based on the data from the interviews, only the most important and frequently used ones are selected for analysis here.

In conclusion, this section mainly presents what kind of non-financial information LMs collect and use to evaluate SMEs. It is shown in detail in this section that LMs are greatly concerned with information such as the SME manager's personality, the operating condition of the machines or equipment, and the inventory of the enterprise. Other non-financial information such as wage arrears can also offer a very strong and sensitive signal that the enterprise is at risk. The "government intervention" and "the macroeconomic condition or industrial situation" could affect the lending from a macro level. In addition, this section also explains exactly how LMs collect this information

by "walking around the enterprise and asking the workers questions", and it also shows that investigation techniques such as random visiting are also very meaningful in obtaining valid information.

5.3 Loan approval

5.3.1 Decision-makers: judgement of loan staff and credit review department (CRD)

From previous literature, it is known there are many official criteria and methods in financial institutions to help evaluate SMEs. According to LM2, there are several key actors in banks who make lending decisions according to formal rules,

> "There are several levels of decision-maker: loan managers and presidents from sub-branches send up the materials to the branch (higher level) for approval; risk managers and review managers from the branch will check the materials and have a discussion in a loan review meeting. After the loan review meeting, approvers like me will check the lending transaction again (and make the final decision). If it exceeds my authority, then I will pass it to the head office for approval. There are also reviewers, approvers or review meetings in the head office to make the final, final lending decision. So, there are several levels of decision-making." (LM2: Transcript 2, P.10)

As can be seen from the above quote, there are six important decision makers who can, in theory, affect lending in a bank: LMs, bank leaders such as presidents, risk managers, review managers, credit review approvers (CRAs), and a higher authority such as the head office. From the research data, it is know that the credit review department (CRD) is an independent department in the bank which makes the final lending decision, it determines if the enterprise can obtain the loan or not. There are normally two credit review approvers (CRAs) in one branch, one is the first reviewer, called the full-time approver, and another is the leader approver. They are experts in reviewing all the materials such as financial statements, and they can distinguish what is true and what is false accurately. CRAs are also independent in making the final lending decision. For example, according to formal rules, even the bank president

cannot command CRAs in the same branch, because the CRAs are normally assigned by a superior branch, so they only need to report to the higher authority. If the CRAs reject the loan, then no one can grant the loan even if the bank leaders want to do so. However, in practice, based on the data and information from all the interviewees, it is known that risk managers' and review managers' roles exist in name only; they only help to give some advices and comments about lending but perform no actual functions. In addition, since the amount of loans to SMEs is usually small, it will not normally exceed CRAs' authority, and thus the higher authority is not very important here either. Hence, the lending decision making is actually focused on the following three roles: LMs, bank leaders and CRAs. According to official criteria and formal rules in banks, it appears that the first lending decision is made by the LM or bank leaders, while the final lending decision is made by the CRAs of the bank. This means if CRAs are against the loan after their review, then the bank cannot not lend it. Is this really the case? Let us explore this question in this section.

From this research, it is known that LMs are the ones who judge all the information and give comments on the SMEs. Following LM4's quote presented before, if the workers' words do not match the SME manager's words or information (about labour costs) provided by the SME manager, and there is big difference between them, then how will LMs judge this and how will it affect the lending decision? LM4 replied as follows:

> "First of all, we will think that the boss is not honest and frank with us; he is concealing something from us, right? This is the effect; then we will think about what the true condition is now, and whether the real risk is controllable or not. (LM4: Transcript 4a, P.3)

The above quote indicates that inconsistency in non-financial information will definitely have some influence on the lending process, which will lessen the LM's confidence in the SME manager. Furthermore, if the non-financial information collected does not correspond to the SME manager's previous words, LM4 will do the following things in order to ensure safety and reduce risks:

"If this situation arises, we will be cautious and more careful about the customer. We may pay more attention to him and dig more deeply about him. […] We may also require him to add more guarantees or collaterals to enhance the safety assurance. […] If all of these problems can be solved and the intended use of the loan is appropriate, then we will still make the loan." (LM4: Transcript 4a, P.3, P.5)

Guarantee and collateral are very important to banks; if you have enough collateral, it is easy to obtain loans from banks. However, about a discussion of the importance of guarantees or collateral is outside the scope of this paper, which mainly discusses the role of other non-financial information in the lending process. And since most Chinese SMEs do not have enough collateral, so it is a great problem if they are required to provide more. Therefore, apart from increasing the customer's default cost (i.e. requirement for more guarantees or collateral), what happens if the LM finds that the SME manager is lying (e.g. overstating the labour cost or annual sales), and how does this affect the lending? LM4 answers the question thus:

"If we are supposed to lend him money for one year but found that guy was not that trustworthy then we may shorten the lending time period, to, let us say, three months. When the lending period is shorter, our risk is lower. This is for small enterprises; their boss's personality is very important." (LM4: Pilot interview transcript 4b, P.7)

Hence, for SME managers, even if the loan is granted, their lending time period could still be shortened if they are proved to be unreliable. This is also a way to ensure safety for LMs and banks. The above quotes also indicate that LMs play an important role in the whole lending process, since they are the ones who judge and distinguish all the information. LM3 considers that LMs should be responsible for the risks, since they have the responsibility to judge the truth of the non-financial information collected, and they are in the first stage of the whole risk-control mechanism. As LM9 also said,

"There exists both true and fake information, so it depends on you or your own sensitivity of judgment. You have to judge what is true and what is false." (LM9: Transcript 9, P.6)

While the identification or analysis of the information collected is a problem, since sometimes it is hard to verify the validity of non-financial information, as LM9 also mentioned in the interview, it is also hard to identify the truth of non-financial information. If the customer is a good liar, he may deceive the lenders and even his whole social network. In this case, the LM can only

> "Depend on his own sensitivity and experience (to judge), a feeling to assume what the customer is like, then to prove it based on his daily behaviour, his character, his social circle and so on. Some bias may exist, and the bias may be considerable, the judgment may not be exactly correct. So it is really hard to investigate and judge this kind of people." (LM9: Transcript 9, P.7)

We can see from the above quote that SME lending in China is a 'subjective' phenomenon, since it is LMs who make the judgment according to all the information collected. LMs have to distinguish the truth or authenticity of the non-financial information all by themselves; the LM's feeling towards the enterprise (or SME manager) is necessary based on the information they have, and this "feeling" could be very subjective and emotional. As human beings, we may make mistakes and cannot take care of everything; for example, LMs maybe cheated by some good liars, so that omissions or bias exist in the lending process. LMs could put their personal consideration (seeking personal gains) into the lending decision, with negative results (i.e., helping unqualified borrowers to obtain loans), as will be discussed in later chapters. After investigation, LMs from banks will write investigation reports and pass all the materials to the CRD for approval.

According to formal regulations, the CRD is an independent department in the bank which should make the final lending decision independently. Then how do CRAs review the materials? LM9 gave some examples to answer this question.

> "If the changes in some data on the financial statement is very big from the first year to the second year, for example, if an enterprise has a fixed asset of 10 million

in the first year, which increases to 20 million in the second year, then the credit review approver may ask questions like, 'Why has it increased so much? Have any new factory buildings been built or any new machinery equipment bought?' If the enterprise's revenue in the first year is 5 million, but it is 10 million in the second year, which is double, then the approver will check if the production and sales have also increased. If the profit margin has increased, they will check whether it is because of the development of technology, or the fall in raw material prices, or labour costs? They will check relevant data and ask you some specific questions. If some data do not correspond with each other, then they will ask why. In that case, you have to make up some excuses and make the lie plausible." (LM9: Transcript 9, P.14)

The last sentence in the above quote is the key point here, as it shows the awareness of LM9. He wants to express that any major change in financial data means those second-year data are falsified, and the examples all show this situation. What about CRAs? Do they know of this situation? The answer is given by LM9 in an indirect way:

"They know that if they require a full understanding of everything, then we can do no lending." (LM9: Transcript 9, P.14)

This why CRAs will ask LMs some targeted questions but not very strictly, and if the LM cannot cover up the fabrications, the CRA will give him the chance to explain:

"As you can see before, he will ask you some questions. At that time, you just need to say, 'I am not quite sure about this, I will double check it again, or I will go and ask the enterprise about it.' Then the approver will understand [that it is false and you need to cover it up] and give you the time [to explain]. You can think about how to explain it and hand in a supplementary report later." (LM9: Transcript 9, P.14)

As far can be seen here, CRAs know that the materials or documents provided by LMs are unlikely to be completely true, but they also know that if they review all the materials very strictly, then no lending business can be done. Therefore, unless they find

something is seriously wrong, they give LMs a second chance to explain or cover up the false statements, which means making the statements look 'better', so everything should look fine on surface at least CRAs' duty is to make sure that there is no very great and serious problem with the lending materials and documents after their review, since they are also responsible for the lending decision. CRAs should be the fairest judges in banks, but it is indicated here that they do not appear to be as fair as they should be. In the case of a 'bad' customer, as will be presented in Chapter 7, the bank leader communicates and discusses with the CRA before lending and the approvers finally agree with the loan, regardless of the risks. Therefore, they could also be affected, regardless of the formal regulations that they should be independent in making lending decision. In practical terms, the CRAs still take LM or bank leader's opinion into account, further details of which will be presented and discussed in a later chapter (Chapter 7). However, normally, as LM9 said, LMs would not make these mistakes before passing financial materials to the CRD, unless he truly does not want to make the loan, and if it happens,

> "At least we have gone through the formal procedure, and it is because your condition is too bad to reach our requirement, you cannot blame us [that you cannot get the loan]. So we transfer the responsibility to the credit review department on this occasion." (LM9: Transcript 9, P.14)

Hence it appears that a LM could also use the CRD as an excuse to reject the loan if he does not want to get the loan approved on purpose. In this indirect way, the LM could transfer the responsibility to the CRD; he will say that the CRD rejected it but not him, so that the borrower cannot blame him and their *guanxi* will not be broken. As far as it can be determined here, to a certain extent, LMs and bank leaders still take precedence over other staff in making lending decisions.

5.4 Summary

Under the circumstance where most people in China do not believe in the veracity of accounting information such as financial statements, this chapter mainly presents research findings concerning how Chinese LMs make lending decisions when they are not able to refer to credible financial statements. Firstly, it is discussed in this chapter that non-financial information is actually more valid than financial information such as financial statements in a real lending investigation. The findings indicate that LMs in China discover the real condition of their customers by checking the non-financial information but rather than the financial one; they use non-financial information to investigate and evaluate SMEs. Secondly, this chapter shows which kind of non-financial information is important in SME lending, and how LMs collect and analyse it to make the final lending decision. Finally, this chapter arrives at the result that it is still the loan staffs who collect, evaluate and judge all the information, and make the lending decision. Apart from false financial statements, this 'subjective' judgement also leaves room for the existence of informal rules (i.e. *guanxi*) in this area, as such rules are followed by these 'subjective' managers. Hence, this chapter also serves a background for the subsequent chapters. Prior to the core chapter (Chapter 6) and beginning to examine what role *guanxi* plays in the availability of credit for Chinese SMEs, it is also very important to present some background information here about loan information collection, analysis and evaluation of SME lending.

Chapter Six: Implementation of *guanxi* in the lending process

6.1 Introduction

The previous chapter, Chapter Five, presents the data on how Chinese loan managers (LMs) use non-financial factors to investigate SMEs. This chapter seeks to show the implementation of *guanxi*, which is another important non-financial factor in the lending process. As LM9 said, "*Most of the business conducted in Chinese banks is the same; it [the goodness or badness] depends on your maintaining of guanxi [with customers].*" (LM9: Transcript 9, P.16) This shows the importance of *guanxi* in SME lending in China. This chapter first presents how *guanxi* helps to develop new customers and maintain old customers for banks, then the purpose behind it. Finally it identifies what 'common friends' (CF) and CF *guanxi* are, and how loan managers use *guanxi* as a non-financial factor and informal rule to investigate SME managers' personality, in particular, which was not discussed in the last chapter.

6.2 Using *guanxi* to develop and maintain customers

Previous literature has shown that *guanxi* has existed in China for a long time, and has wide effects on the Chinese society (Troilo and Zhang, 2012; Fan, 2002; Lovett *et al.*, 1999). Regarding banks, since the competition between banks is currently fierce (Yuan, 2006), finding customers is a challenge for them. The research findings in this section show that loan managers will develop new customers by establishing the *guanxi* with them first, and then achieving their marketing goal by using this *guanxi*. As LM4 said,

> "How to find customers? […] one way was going out and visiting firms one by one, to find new customers. Another way was based on previous customers, by asking them to introduce new customers. For example, if I had 60 customers before, and 30 percent of them would like to introduce some more, then I may have 18 new customers at least, which is enough for me. […] most are their friends or business partners." (LM4: Pilot interview transcript 4b, P.4)

The first marketing strategy mentioned by LM4 is also related to the implementation of *guanxi*. LM5, who is from a city commercial bank (CCB), talked about finding new customers by "going out" and shared his experience in detail of how to establish *guanxi* with the customer:

"I do not think the business should be the entry point, they will not be interested if we talk about it straightforwardly. Many tenants, when they hear you are from banks, [they say] 'No, no no, I do not want it, go away, go away, go away!' […] I will praise him at first, saying for example, 'Your business scale looks quite big, boss, and I think you have been in this market for a long time, right?' And he might pick up the talk, 'Yes, I have been [doing business] in this market for about ten years.' Then I need to ask something about his products, and I should know about the products in advance, at least I should know where these products are used to. I might say something like this, 'Oh, I know this one, it makes big profits, right?' I will talk with him gradually and slowly, and then I will guide the topic to our bank, for example, 'I am from XX bank, have you ever heard of or had any contacts with our bank?' Maybe he had a credit card from our bank, then I might say, 'Our finance products are quite good recently, have you ever noticed anything about them?' 'Not really.' Then I will hand him a product advertisement leaflet immediately or open my smart phone and show him online. If he is interested in it or he has borrowed something similar from other banks, he may say at first glance, 'Your product has a lower interest rate [than the one I have taken]! Although it is only 0.1% difference, your interest is lower! Besides, your bank is also near here; I would rather to borrow from you!' And finally, I will do the registration for him, and when his previous loan is about to expire, I will make the financial plan for him in advance, give him a phone call and ask him to come. This is how we develop new customers." (LM5: Transcript 5, P.16, 17)

LM5's customers are mainly tenants in a market near his bank, and he is using quite a smart way to develop new tenant customers. He builds the *guanxi* with the tenant by praising him firstly, and then continues talking about something else which is irrelevant to the lending business. When the tenant lets his guard down, and their *guanxi* is built, LM5 will at last introduce the financial products to him. Normally, Chinese people do

121

not like to talk about business directly and straightforwardly, and this is particularly the case between people who are not familiar with each other; it is the same in the SME lending area. If LM5 introduces his products directly in the beginning, the tenant customer may feel embarrassed and uncomfortable since they are strangers, but in this way, people will feel more relaxed and happy to communicate with each other. I think this is also a very good marketing strategy based on the establishment of *guanxi*. Thus, one key point of establishing *guanxi* is to make people feel comfortable first. LM5 also provides another counter-example to show the importance of establishing *guanxi* with customers in this way initially,

> "… someone who was from XX bank and was selling credit card business to one tenant, he said, 'Hi, boss, are you interested in applying for a credit card from our bank?' He said it directly to the tenant and I was just sitting there nearby, and the boss replied, 'I have lots of credit cards, I do not need it.' Then the guy from the bank, I am not sure if he was really from the bank or just from an outsourced company [which helps the bank sell credit cards], he responded unexpectedly, 'Ok, I see, you have too much money to burn, boss.' This is quite an unfriendly sentence; the boss was so angry and was about to hit him when he left. (LM5: Transcript 5, P.17)

The example above shows what happens when the loan manager goes straight to the business, and although it is about credit card business, I think the situation is the same when 'selling' loans. The example is a complete failure and even offended the tenant customer, since there are lots of bank officials who come to the market to introduce and sell their financial products, with the result that the tenants get bored with them. This is also why the tenants say "go away" to those people who come from banks, as seen in the last quote. As I mentioned just now, there exist informal rules in Chinese society. For example, when two Chinese businessmen meet together, particularly if they are strangers, they do not like to talk about their business immediately and straightforwardly, but they will build and improve their *guanxi* first. Therefore, when this loan manager broke this 'informal rule', it is no wonder that he received a negative reaction. The conversation continues,

"… In my opinion, we are selling things and our customers have the right not to buy our products - why must they buy them, right? And we should not be sarcastic to our customers. So, the entry point is very important; if you talk about something that they are sensitive about straightforwardly, no way, you cannot do it like this. Even if you know that he needs a loan, you should not ask him how much does he want at the very start, he will just feel that you are interrogating him. Our customers are not criminal suspects, right?" (LM5: Transcript 5, P.17)

We can see from the above quote that the entry point is very important, which mean the establishment of *guanxi*. LM5 considers that LMs should establish their *guanxi* with SME managers in an acceptable and comfortable way, and in the above example and also previous quotes, this is done by starting to chat about other things, but not about the business directly. In addition, as LM3 said,

"… in the beginning as two strangers, you must find a common language, you need to find some common interests. You may talk about some family affairs after a long interaction, chat about current news, or even football matches if both of you like watching football." (LM3: Transcript 3, P.11)

Guanxi is established on the basis of communications, which communication could be in the way of 'chatting' naturally. And *guanxi* can be used to reduce the distance between borrowers and lenders, close the gap between them and bring them closer together. However, although it may be easy to establish *guanxi* between two strangers since a common language is sufficient, it is difficult to develop and maintain the *guanxi* later. The establishment of *guanxi* and the development or maintenance of *guanxi* are two related, but subtly different concepts. LM9 considers that *guanxi* is developed by

"Visiting our customers frequently, during or after working hours. Just make friends with them. […] If we have the same hobbies, like climbing mountains, playing badminton or swimming, then we will set up a date and go out together." (LM9: Transcript 9, P.16)

So *guanxi* is developed and maintained through frequent social interactions. LMs and SME managers will engage in social activities together to improve their *guanxi* and friendship. However, maybe the "friendship" here is not what we normally understand by that term. They are probably not truly making friends with each other, but, as we are less likely to defraud our friends, LMs are probably just using this "friendship" as a tool to ensure the safety of the loan, as will be discussed in detail in the next section. Moreover, they will contact each other often during the lending process. The following conversation with LM5 shows the type and frequency of these interactions.

> **ME:** *So, do you meet every day or make phone calls?*
>
> **LM5:** No, we will not go every day, sometimes it is just passing by, encountering each other. We might just nod our heads or wave our hands when we see each other.
>
> **ME:** *Maybe chat a little bit?*
>
> **LM5:** Oh, yes, a small chat sometimes. If he truly wants to know something about the products of our bank, or truly wants to take a loan, at that time, if you have already built this *guanxi* with him, I think his first consideration should be you, it should not be others, right? He will come and ask you first.
>
> **ME:** *Yes, yes.*
>
> **LM5:** So, we have to make good *guanxi* with them; there is no other way. (LM5: Transcript 5, P.2)

There are two salient points to be noted from the above quotes. Firstly, the 'interactions' do not necessarily need to be formal meetings, but also take other forms such as a small chat or even just a greeting; *guanxi* can be also developed and maintained through these minor activities. Secondly, after the establishment of *guanxi*, LM5 also considers that helped in developing the business, which also shows the importance of *guanxi* in the lending process.

There exist both formal and informal management systems in Chinese banks, with the normal function of the bank relying on the formal system, such as management structure and regulations. Meanwhile, Chinese banks also have some informal procedures to help find more customers outside, which is determined by the internal demand of the bank: making more profit. "Customers introduce customers", indicated by LM4 at the

beginning of this section, is a much more informal method to find new customers for banks. This informal method is also an obvious use of high-level *guanxi* of existing customers. Old customers introduce their friends or someone they know to the bank, and which also gives the new customers a chance to establish *guanxi* with the bank in turn, and they might also use this 'connection' to take some loans from the bank. Like LM4, LM5 also implements *guanxi* with old customers to develop new customers.

> **LM5:** On the one hand, we need to develop new customers in our daily work, but on the other hand, we have to maintain the *guanxi* with our old customers. If we maintain *guanxi* with some old customers, they may also introduce new customers to us. This is what we hope to see mostly, and the success rate of marketing is also highest in this way.
>
> *ME: So, just what will you do to maintain your old customers normally?*
>
> **LM5:** Eh…talk about the daily life of our families and so on. Anyway, we want to make our *guanxi* closer, and make them trust us more. Then when you want to sell some banking products to them afterwards, it is easier for them to accept since the trust degree between us is higher. (LM5: Transcript 5, P.2)

Thus, as we can see from the above quotes, LM5 also explained a little bit in response to my question of how to maintain old customers, and he pointed out one important element of *guanxi,* which is *xinren* (trustworthiness). The purpose of talking about family affairs or business scales is also about improving the *xinren* between the loan manger and the SME manager. When their degree of trust improves, their *guanxi* is also better and hence it is easier to get the business done. Moreover, as LM2 said in the interview, *"The guanxi of banks and enterprises is based on the foundation of* xinren *(trustworthiness)."* (LM2: Transcript 2, P.13) Many prior studies and Chapter 4 of this present study have also shown that trust is the foundation of *guanxi,* which is used to smooth business transactions and reduce risks in China (Chen and Chen, 2004; Yen *et al.,* 2011; Kaynak *et al.,* 2013). In the SME lending area, it seems that *xinren* or trustworthiness is also important throughout the whole lending process. It could consolidate the *guanxi* between LMs and SME managers, and which takes the SME-

bank relationship to a personal level. So, maintaining *guanxi* between banks and SMEs is also about maintaining a trustworthy relationship between the two parties. This form of trust building is necessary especially in the absent of valid accounting information. When I asked EM5, who is the owner of a medium-sized manufacturing enterprise, whether he would still have contact with the bank after the repayment of the loan, he replied as follows,

> "Of course, it is a long… [process]. If we do not cooperate today or this year, it does not mean we will no longer cooperate. […] we will still have a connection with the bank, since you do not know when you will need funds. The goal is that we want to have good trustworthy and creditable *guanxi* […] This is what other [things] cannot compare to, as it is very important." (EM5: Transcript 13, P.4)

The above quote indicates that **the establishment of *guanxi* is only a beginning, and maintaining *guanxi* is carried out through long-term and continuous interaction.** I think the last sentence of the above quote means that *guanxi* has advantages over other financial or non-financial factors in obtaining credit, so this is also the reason why EM5 wants to maintain *guanxi* with the bank even if he has no business with it: this *guanxi* connection may help him obtain another loan if he needs in the future.

6.3 The purpose of maintaining *guanxi:* risk control?

The above subsection shows that *guanxi* can be used to develop new customers and maintain old customers, but these are not the only functions of *guanxi*. LM3 and LM5 have already spoken a little about the way they maintain *guanxi,* which is through 'chatting', but the purpose of chatting is not just to get along well with SME managers,

> "You can talk about all these things, but finally you need get back to the enterprise, the purpose of the chatting is to discover the condition of the enterprise and to find out what the boss has been doing recently from his own mouth." (LM3: Transcript

3, P.11)

Not only LM3, but many loan managers (e.g., LM2, LM4) mentioned that chatting with people is a useful method of obtaining information during the lending investigation process (see Chapter 5). So 'chatting' is not just a tool to maintain *guanxi* here. As LM5 said,

"If you chat with him gradually and slowly, talk about his operation a bit, then you may also get to know about the condition of his operation. As I said just now, at least you can know how many years he has been here and what kind of products he is selling. What about the sales condition? The prospects? What about the suppliers and buyers? Do they have stable suppliers and buyers? We can get all this kind of information [by chatting]." (LM5: Transcript 5, P.17)

As we can see from the above quote, the purpose of 'chatting' and maintaining *guanxi* with customers is that it is easier for LMs to obtain information about the enterprise, LM9 also mentioned this in the interview. And LM4 considers this information is very important,

"Because in our experience, no matter what company or enterprise, risks or problems do not emerge suddenly; some emergency may happen, but it is rare. Normally, there must be some early signs before the risk or problem, and we can sense these signs or get some information through the daily interactions with our customers." (LM4: Transcript 4a, P.7)

Therefore, maintaining *guanxi* could obtain internal information and thus control the risks, especially when public information such as financial statements is not reliable and sometimes worthless (as discussed in Chapter 4). And from LM4's quotes here, we can see that early signs are important since they can be used to sense the risks (of bad loans) before they happen. LM4 also gave some examples to explain how it works,

"For example, in our normal chatting, if you find that the customer wants to borrow money from others [not banks] through private lending or something like that. Or

it does not even necessarily need to be borrowing money. To take another example, the customer has got loans from several banks, but his *guanxi* with one bank has not been good recently. These things will affect the safety and stability of that enterprise's financing. Or maybe in another chat, he tells you something like it was hard to get money from downstream enterprises, which will affect his normal operating cycle. So these are all risk signs that can be sensed before the problems happen." (LM4: Transcript 4a, P.7)

Two insights are revealed from the above quote. Firstly, these 'early risk signs' are sensed from normal chatting or *guanxi* interactions with their customers. Secondly, the risk signs are information related to the enterprise's financial condition or operation condition. LMs need to obtain more information to discover the enterprise's condition, and then finally reduce the default risks which is also the purpose of lending investigation. Many LMs such as LM2 think that they should make friends and maintain *guanxi* with their customers since *"It is easier for you to control risks if you are friends."* (LM2: Transcript 2, P.7) LM3 gives the reason,

"As friends, we will be frank with each other. At least we do not need to try to determine if he is lying or not or worry about losing contact suddenly; at least this kind of thing will not happen [if we are friends]." (LM3: Transcript 3, P.11)

We can see here that *guanxi* is like a barrier that divides people into friends and ordinary relationships. People inside the same *guanxi* circle are friends and are more likely to be frank with each other, while people outside the circle may engage in fraudulent behaviour. Therefore, making friends is a way to maintain *guanxi*, bringing a trustworthy and open atmosphere to the circle, which is also one characteristic or benefit of *guanxi*. LM2 also explains it in detail,

"In the field investigation period, since we are not that familiar with each other, we will not talk so deeply, and you may not tell me anything about these but talk mainly about business. But **if we are friends,** you will tell me everything, no matter what the problems in the enterprise's operation or other investments you want to make. **Then it is easier for me to estimate your risk**." (LM2: Transcript

128

2, P.7)

If two people are friends, which means their *guanxi* is very good normally. But still, I think one important purpose of maintaining *guanxi* in the form of making friends is to share true information and then finally control the risks. It could be used as a tool to secure the safety of the loan here. When I asked EM4 the following question,

> **ME:** *So what do you think your guanxi is like with loan manager? Like friends or just for business?*
> **EM4:** like friends mostly.
> **ME:** *So you are friends with most of the loan managers after the lending?*
> **EM4:** This is definitely, because we know each other better after the interactions.
> (EM4: Transcript 12, P.9)

Other SME managers also have similar answer, so it is verified from the SME side that they also would like to be friends with loan mangers. EM4 considers that interactions improve their understanding about each other and which is good for the friendship and *guanxi*. It also verifies the saying that *guanxi* is developed through social interactions before. LM9 also talked about how they will maintain *guanxi* with customers and his thinking about making friends with his customers:

> "They are also your own social resources if you do not stay in this bank anymore, so it is not just for the bank's business. Furthermore, you are dealing with customers all day long in the bank, if you do not make friends with them, then there is no fun in your life. They are both your customers and friends, and this is your lifestyle. Everyone has to make friends, right?" (LM9: Transcript 9, P.16)

LM9 considers that the customers are also his social capitals, which could still be used even if he transfers to another bank. Hence, the manifestation of this social capital is dependent on the maintaining of *guanxi*. If he maintains *guanxi* well with his customers, this *guanxi* can turn out to be valuable and rewardable social capital. As a potential social capital, it may not be used immediately at present but probably in the future, which means LMs can exploit it when in need, because the *guanxi* is already

established, so they do not have to waste time to establish it again but just need to enhance it in the future. Besides, we can see from the above quote, it is LM9's own needs to make friends as a human being. Therefore, at least from LM9's point of view, it (maintaining *guanxi* by making friends) is not just about controlling the risks, it is also for self-profit-oriented purposes and fulfilling his own needs.

Hence LM2, LM3, LM9 and EM4 consider they should be friends with their counter-parties, although they all call them friends, I think this 'friendship' may not be true friendship. There are similarities between developing friendships and maintaining *guanxi*; for example, they all need long-term interaction, but I think making friends is more wholesome to some extent. You may want to make friends with someone just because you like them and you want to be friends, while maintaining *guanxi* in the form of friendship is often more instrumental and interest-oriented. It also involves interest exchange and transaction, or, as mentioned in section 6.2 and also discussed in this section, LMs might only use it as a means to ensure the security of the lending. Hence, loan mangers are probably not truly making friends with SME managers here in the SME-bank lending area. Other interviewees, such as LM4 and LM6, also said they are not truly friends with their customers. LM4 thinks that *guanxi* is just for business purposes.

> "Banks and enterprises are all doing business. The difference is that enterprises sell real goods, but we sell 'money' and also earn money. Money is also a kind of commodity to us. We just discuss our requirements with each other and try to get the business done. During the business time, we may contact each other often. From our perspective, we need to control risks [by doing so]. From their [enterprises'] perspective, they also want to know if there are any policy fluctuations which may affect the lending. These are all for business. Take me for example; I have had hundreds of customers, but still have contact with only a few now. We may call each other brothers during that time [the lending period], but this does not mean we are true brothers [or have a real brotherly feeling towards each other]. It is just for business and face." (LM4: Pilot interview transcript 4b, P.5, 6)

LM4's words verified my earlier impression. It is likely that LM4 speaks the truth here; he also considers that this 'friendship' only lasts during the lending process, but after that, they might not contact each other anymore. This is also my opinion; I think some of them might become true friends eventually, but not all of them. *Guanxi* is the way of making friend as a tool to smooth the business and control risks. Although LM4 does not consider his customers as his friends, he will still care about his customers and contact them more often when they are in trouble, which is also part of the maintenance of *guanxi*.

6.4 *Guanxi* circle (network) and 'common friend' (CF) *guanxi*

As discussed in Chapter 5, SME managers' condition is a very important non-financial factor in evaluating SMEs, and as LM4 mentioned in the interview,

> "With SMEs, we mainly pay attention to their bosses. That is because the accounting and financial management systems in China are not perfect, so we may not be able to find problems from their financial statements alone. So, given that the overall economic environment is normal and stable, we will pay more attention to evaluating the 'person' [SME managers]." (LM4: Pilot interview transcript 4b, P.2)

LM4's statement above shows the importance of investigating SME managers, but how are these SME managers investigated? As the conversation continues, LM4 adds,

> "One's personal credit is an ambiguous thing; you cannot say a person must be trustworthy if he meets all your listed requirements. You can know someone's personality only after for example, five years' personal interaction or business *guanxi* with him." (LM4: Transcript 4b, pilot interview, P.2)

Guanxi is an efficient method and an important type of social capital (as shown in the last two sections) and is also widely used by Chinese LMs to solve this problem. From previous sections and LM4's words here, it can be seen that LMs can investigate SME managers by making good *guanxi* with them, since they obtain more information

and get to know the SME managers better directly from the *guanxi*, but it is a long-term process which takes time. However, this section discusses another type of *guanxi*, the CF *guanxi*, and shows how it is used to investigate SME manager's personality objectively and efficiently.

When I asked LM7 about how Chinese LMs investigate SME managers' personal credit in detail, apart from official criteria such as the credit recording system, LM7 replied as follows:

> **LM7:** We should have some understandings about the customer from 'outside' before the lending first definitely, maybe we know he operates the enterprise well, or other people comment that he has good credit, [to know] something like this in advance.
>
> *ME: So from the people around him? And what questions do you ask these people?*
>
> **LM7:** we were knowing these [things] during our ordinary chatting or interactions, it is not like this that we ask them directly when we are doing the lending business, that [ask directly] is just like the police examines suspects, we will not do in this way. Generally, we will investigate more indirectly in advance. (LM7: Transcript 7, P.6, 7)

The 'indirect' way of investigation and the comparison with the police indicate that *guanxi* investigation has its own norms, albeit that they are likely to be only informal rules. Moreover, we can identify two important norms from the above quote. The first is that the LM should have a basic understanding of the enterprise or the manager before lending, and the investigation of the SME manager starts during the pre-lending period. This kind of understanding or investigation is also related to reputation, because it concerns other people's comments about the SME manager or the enterprise; without these, it is very difficult for the LM to know if the SME manager or the enterprise is sound or not. LM5 replied as follows when I asked him a similar question about how to investigate SME managers' personal credit:

> "…we can see his reputation in the market; if he is always motivated and has good personality, then normally he will be popular in the market, or at least many people

know him. If he always owes others money and does not repay it, many people who hear his name and may say, 'Oh, this guy is not good.' If they say it directly like this, then it means his credit is not good. This is more straightforward than a credit report, right? We know immediately from it. Although the money he owes may not be much, he has a kind of bad record there, and a lot of people in the market know it, which makes big trouble for him." (LM5: Transcript 5, P.8)

Therefore, LM5 identifies the tenant SME manager's personality from his reputation in the market, and this reputation is reflected in other tenants' comments towards him in this market. This method needs interaction with people in the same market because LMs need to collect these 'comments' from them; the process of collecting this kind of information involves *guanxi*. We know that *guanxi* is about interaction between people, and in this case, LMs need to use *guanxi* to collect these 'comments'. Hence, to some extent, LMs are in fact using *guanxi* to investigate the SME manager's reputation and then personality.

The second norm seen in LM7's quote before is that LMs investigate in an indirect and 'comfortable' way, which is similar to the way in which they develop new customers with *guanxi*. This means, in LM7's words, that they should not investigate SME managers like policeman interrogating criminal suspects. They should not make SME managers feel embarrassed and uncomfortable during the investigation. And since most of the SME managers in China will not talk about their negative aspects themselves, which makes it difficult to have a clear picture of the borrower's condition, such as his personality. Therefore, Chinese LMs investigate in an indirect way; that is, by asking "people around" about the SME manager's condition. LM5 also holds the same opinion,

"… we can ask his fellow villagers, other tenants around him or someone who has done business with him before. They should know him better than us, they know what he is like and what he is doing now. […] We will not ask these 'common friends' directly such as by asking, 'What is his personality like? Does he often lie to others?' Not like that, we will ask indirectly such as by asking, 'Do you know this guy?' If he says yes, then we will ask briefly, saying, for example, 'Is he cool [good]?' We ask in a relaxed way, just like a joke, and he will understand us, right?

Then he will tell us if there are any bad things about the customer. […] If he does not know our customer well, he will not chat normally, he will tell you directly, 'I am not quite sure about him.'" (LM5: Transcript 5, P.7)

Since the three parties, loan manger, SME manager and the 'people around' the SME manager, all know each other, so we term these people around as 'common friends' (CF) here. And we name the *guanxi* among them as the direct 'common friends' (CF) *guanxi*. Hence, as we can see from the above quote, even when asking these CFs about the SME manager's situation, LM5 still asks in an indirect way. He does not ask about the borrower directly but lets the CF understand what he means. I think the advantage of asking indirectly like this is that LM5 can let the CF decide whether to give information about the SME manager or not, which avoids a situation where the borrower is not good but the CF might feel embarrassed if he says anything negative. Moreover, as LM5 said, the CFs will understand and tell the truth if they want to. Therefore, LM5 does not push CFs but lets them choose whether to answer the question or not by themselves in this way. As we have seen so far, LMs have a unique informal SME-manager-evaluation system which is based on *guanxi*, and there are a clear set of rules and norms governing the using of *guanxi* in this system. I believe the purpose of these norms, i.e. investigating through CFs or asking 'indirectly', is to have an objective judgement or evaluation of the SME manager. LMs do not want only to hear from SME managers themselves or just read the financial statements.

Other LMs' words also show that this practice is very common and LM3 considers that these CFs could be people in the same industry,

"… let us say the machinery industry or the pharmaceutical industry, then people in the same industry circle should know him well. We can inquire about him through other people such as by asking what his current condition is and whether enterprise has any operation problems. They will know things better than we do." (LM3: Transcript 3, P.14)

Hence, as we can see from the above quotes, another important reason why LM3

and LM5 like to ask these CFs is because they know more about the borrower, since they are normally in the same industry and probably have more interactions than LMs do. LM9 made a similar statement:

"If you really want to investigate a customer, you can start from his social circle, someone who he knows well or has a good *guanxi* with, and get in touch with as many people as you can inside the circle. Then ask them about your customer's condition. The results may be rough, but at least you know something about him and what he is doing now. It is better than nothing." (LM9: Transcript 9, P.6)

In contrast to LM3's previous statement, the social circle in the above quote refers to that *guanxi* range is not limited to those in the same industry, but could mean the borrower's ordinary friends as well. LM9's investigation strategy here is to try to get as much information as he can by asking more people. At the same time, the CFs are not restricted to the same industry or friends, as LM3 himself said.

"I had after-loan training several days ago, and as the teacher said, we even need to get along well with the boss's wife, since she can also release some information about the boss or the enterprise; it is best if we can get more information." (LM3: Transcript 3, P.11)

Thus, even the SME manager's wife could also be CF here to provide useful information. LM9 also uses various *guanxi* circles to identify the borrower's latest conditions, personality or morality:

"You can also use your colleagues' *guanxi*, since your colleagues also have a lot of customers, and their customers' social circles can also be your information resources. You can get the information you want from them." (LM9: Transcript 9, P.6)

From the first two sentence of the above quote, we can see the **transferable feature** of *guanxi* as social capital; it is transferable between people. The last sentence shows that LM9 could obtain the information he needs from these CFs and their *guanxi* circles

through his colleagues as intermediaries. In this case, these CFs or their circles may know the customer LM9 is investigating well, since they are all SME managers and might have connections or *guanxi* with each other. Hence, LM9 could use his colleagues to obtain information on the borrower from their customers and the circles they belong to. This process is called the transferring process of *guanxi*, and the *guanxi* between LM9 and common friends is named as indirect 'common friend' (CF) *guanxi* here. LM7 considers that he can also use the *guanxi* with LMs from other banks,

> "…we will ask for some information indirectly, like though loan managers from
> other banks. For example, if he has a loan from another bank, then we will ask that
> bank about his situation. Or we can also ask his suppliers and buyers, all of them."
> (LM7: Transcript 7, P.7)

If other LMs have made loans to this SME manager in the past, they have previously had lending *guanxi*, and they should have investigated and found out something about this person already, so it is easy for LM7 to obtain some information from them. So the CFs here refer to LMs from other banks, while LM9 considers that the CFs are not necessarily to be individuals, but could also be other *guanxi* bodies,

> "…other banks, government departments, some banking supervision departments
> and so on, these varieties of *guanxi* [bodies] can also be your information
> resources." (LM9: Transcript 9, P.6)

Hence, it can be seen that CFs could be people who know the SME manager or relevant organisations that have connections with the target enterprise. Similarly to LM9, LM3 and LM6 uses upstream and downstream enterprises inside the same industry to investigate, they consider that it is a comprehensive way to understand the target enterprise. However, the investigation through organisational *guanxi* bodies is still based on individual level interactions, it is the people who are interacting with each other in these activities. Hence, it seems like that there are no formal rules for investigating SME managers, but there are some informal norms for doing the evaluation work. The 'indirect investigation' continues throughout the whole process in

fact, and involves the collection of non-financial information of the SME manager or the enterprise through their CFs. So how do they collect and investigate the information in detail? As LM9 said,

"When you have a range of customers, for example, in the construction industry, when you know a range of construction enterprise managers in this [the name of the place, deleted here], including both good and bad enterprises, if you want to ask about one construction enterprise manager's condition, like A's condition, then I will ask another construction enterprise manager, B, who may know A well, about it. They are in the same industry and they have a same social circle (network), and information or news, particularly news about the bad ones will circulate quickly inside this social circle. For example, they may even know who uses thinner steel pillars (which do not reach the standard quality requirement) in buildings; others (outside the social circle) may not know about it, but this quality issue spreads quickly inside the social circle. So it is easy to ask about one person's current condition through another manager who is also inside the social circle." (LM9: Transcript 9, P.5)

The first sentence in the above quote actually defines the CF *guanxi* investigation method, and shows how LMs investigate SME managers with this *guanxi* and *guanxi* circle (network) in a specific example here. The second sentence shows the rapid rate of information spreading inside the same *guanxi* circle. And the rest sentences show the exclusiveness of *guanxi* circle (network), which means only people inside the same circle could get to know the information, while others outside do not have the chance to know. So *guanxi* circle could produce trust among the members inside and reduce malfeasance indeed. But overall, all these features of *guanxi* circle (network) show the usefulness of *guanxi* on the internal information collection process, and which eventually benefits the lending investigation. LM2 gave a specific example to show how it works.

"Yes, or even like this, for example, if I want to make you the loan, then I may talk to Boss L [the person who introduced this interviewee to me, so we have 'common friends' *guanxi* here] to ask her about your condition before making the loan. In

this way, I can find out about you more objectively and control the risk better."

(LM2: Transcript 2, P.7)

It can be seen from the above quote that LM2 considers that the advantage of investigating through CFs is that it is objective. As it is more objective, then this means that the information used to evaluate the SME manager is truer and thus they can have better risk management of loans. LM9 also provided a more detailed example to show what kind of information he would seek in his investigation.

"For example, one of your customers told you how rich he is or how much capital he has, but another SME manager who has *guanxi* with him may tell you, 'I know that guy, I have done business with him before, he does not have so much capital. He even owes money to me.' So we can easily understand that customer's personality, and when there is a range of people you know, you can combine all the information and reach a comprehensive conclusion about him. So it is easy to know one person inside the social circle. Maybe the result is not exactly accurate, but it still can reflect someone's personality more or less." (LM9: Transcript 9, P.5, 6)

As can be seen from the above quote, the investigation is conducted through a common friend's comments about the SME manager, and it appears that LM9 places more credence in the CF but rather than the SME manager's own words. However, this belief is not unquestioning, meaning it does not just depend on one common friend's comments. The result of the evaluation of the SME manager's personality is based on the attitudes of a group of common friends' attitudes towards the borrower, which is very "comprehensive". Another point in the quote shows that *guanxi* circle (social network) is very important, and it also shows the "ease" of obtaining relevant information inside the circle. If you are in the same *guanxi* circle which means you have *guanxi* together, then it is easy to obtain the information you need, which also shows the importance of *guanxi*. Otherwise, just as LM9 said in the previous quote, the exclusiveness of the *guanxi* circle (social network) will put the information out of your reach.

As can be seen, the investigation of SME managers through CF *guanxi* has its advantages. For example, as LM5 said,

"…information collected by the way of 'common friends' is truer, because some information can be falsified, and some customers are too bad to know how to deal with us banks after a lot of interactions with us." (LM5: Transcript 5, P.8)

Not only LM5, but also other interviewees like LM2 mentioned that it is comparative more objective than just listening to the SME manger himself. Moreover, some LMs also explained the reasons why they can obtain true non-financial information through CF *guanxi*,

"Secondly, how to say it, since it is different in China and other countries, there is an old Chinese saying: 'people in the same industry are always enemies indeed.' If we are in the same industry, then I will not say a good word about you normally; I will only say something bad about you. So we can find some problems in normal chatting." (LM2: Transcript 2, P.9)

"Maybe their *guanxi* looks good ostensibly, but there is actually a conflict of interest behind it, so he [the common friend] would tell you the truth." (LM9: Transcript 9, P.5)

LM2's opinion coming from the old Chinese sayings does make a certain sense; this situation does arise in China. LM9's saying also shows a very interesting phenomenon in China: It may look like that the borrower and the CF have good *guanxi* with each other, at least they are apparently friends, but actually they are not. This phenomenon often happens in the Chinese business sector. The CF may seem nice in front of the borrower, but he might speak bad words or do bad things behind borrower, especially if they two are competitors in the same industry. So LM9 considers this is why the CF would tell the truth especially bad things to him normally. But is the CF really so objective as he looks? Some other interviewees have different opinions,

"Take an example, if he and I are not that familiar, I definitely will not speak badly

about him, 'oh, he, he should be all right I think.' I will definitely say like this, right? Because a Chinese business man will not like to offend others normally. So we need skills to judge from other aspects; for example, from their products, or from his interpersonal relationships to evaluate what his personality is like." (LM3: Transcript 3, P.14)

"If both of us know him, then the bank will come to ask something [about him], usually. And we are partial to the enterprise side more or less. Let us say, if he can only get 6 marks actually, we will give him 7 marks. I think it is helping each other." (EM4: Transcript 12, P.10)

Most of the interviewees consider that common friends' words are relatively more objective, but LM3 does not; he thinks it is determined by Chinese people's character, which is that they do not like to offend others, particularly businessmen who need each other's support to do business, so that they will mainly speak positively about others. If they speak negatively, they will offend and embarrass others, but they are in the industry and have to meet each other often, so it is not good for them to offend others. As EM4 says, SME managers will support each other and give a positive evaluation of each other normally, and as I realised from LM9's previous quote, a LM's belief in CFs is not unquestioning. So how do they verify if the CFs are telling the truth or not? How to test the integrity of these common friends, as they may not be telling the truth either. In the above quote LM3 mentioned using of some "skills" to solve the problem, and he added,

**"This is about your conversation skills. We will not ask directly what the boss is like, definitely not. Maybe we can find it out through his products. To give an example, [we will say] 'Oh, it seems like that this product sells well here.' Then the boss may say, 'Yes, it sells well in my company, but not good in XX [another] enterprise.' He will talk about that himself, maybe even unconsciously, but you need to listen and keep it in mind. This is definitely about skills, we will not ask the manager directly about the condition of XX enterprise. There is something… eh… between people." (LM3: Transcript 3, P.14)

As we can see here, the "skill" here is also about an 'indirect' investigation method

through CFs. LMs need to find clues about the SME manager in a 'beat around the bush' way. When people are looking for information, many people might wonder, if they do not ask the question directly, then how they can get the answer. One aspect is actually ignored here: the reason why people need to use specific skills to obtain certain information is because the responder does not like to provide it directly, so even if you ask very clearly, you still cannot get the answer if the responder does not want to give it. To give an example, if LM3 asks directly about the condition of the borrower (i.e. his personality) from this common friend, if the common friend does not like to answer, then he would not provide any valid information. In this case, the 'beat around the bush' way serves a very special function here; it is for the same the LMs when they are developing new customers (as we have presented before). We need to guide others to say what we want to know through chatting or dialogues, but not by asking them directly. The 'beat around the bush' way means the speaker uses some hints or strategies to guide the audience's mind and reveal what the speaker wants to know. In this case, LM3 did not rush directly into the theme (which is about the SME manager's condition) either, but asked some irrelevant questions about the products of the enterprise as a warm-up attitude. He pretended to ask these questions causally and might even let the CF feel that he cared about him, which is in a 'beat around the bush' way. Thus, the skill here is that instead of asking directly, LM3 gives the audience (common friend) an interesting topic and let him release the information himself unconsciously. Moreover, these indirect questions or topic might look like insignificant from the common friend's standpoint. However, they are asked with purpose from the LM's standpoint indeed; some key information is actually obtained clearly in this way. Apart from what is said in this quote, the LM could even get more details by contradicting the audience. For example, from the common friend, we can learn that XX enterprise's sales condition is not good, so if LM3 goes against the common friend by saying, "you might not be right, I have heard that their products also sell well", I am sure the common friend will defend himself by providing more detailed information about the conditions of the borrower and his enterprise. Since this information is released by the CF himself unconsciously, this means the trustworthiness level of the information is also high since the responder has not prepared for it. Therefore, if LM3 wanted to make a loan to XX enterprise, he would definitely be careful about it when he heard this information. Other interviewees

also mentioned some methods to reduce the bias and obtain more objective information,

> **"**If someone speaks well of you, then I will chat with other three or five more people. It is very rare for all of them to speak well of you. If it is truly the case that all of them speak well of you, then you must be good. […] So we can identify it through a lot of people. For example, there are hundreds of tenants in a market, then I can chat with five or more tenants who are near you in order to get your information. We can find some clues or problems through normal chatting. (LM2: Transcript 2, P.9)

As in the quote presented previously, LM2 and LM9 consider that people in the same industry or so called CF will not speak well of each other, which is completely contrary to LM3 and EM4's viewpoints. I will not discuss who is correct here, but LM2 pointed out a way to verify the truth of these common friends' words in the above quote, which, I think, is more important than the 'right and wrong' here. Therefore, the way to reduce the bias is by asking more people and verifying it through several people, but not just listening to one CF. As LM8 said,

> "Many things, we know in our heart actually. […] Maybe we are not able to get the truth from only one person, but it is also impossible for everyone to speak well of him. We can [investigate] through various social circles, asking different kinds of friends. (LM8: Transcript 8, P.9)

Hence, both LM2 and LM8 consider that if the sample of CFs is large enough, then the bias of untruth could be reduced. This is also fairer to the target of the investigation, since one person may lie, but there should be someone who is telling the truth if several people are asked. However, in the above examples, is it possible that the tenants would prepare for the investigation in advance and help each other by speaking well about others? Because they are in the same market and know each other well, it is easy for them to deceive the LM together. LM5 provided a solution.

> "We have considered this problem; they may collude with each other and only say good things. But our customer does not know whom we will ask in advance. So

we can do it like this; for example, if our customer's tenant number is one in the market and the number three tenant is opposite to him, maybe we will not ask number three [about number one's condition] but randomly ask number five, so that they are not able to prepare for the conversation in advance." (LM5: Transcript 5, P.8)

So the solution is to "ask randomly" since the CF could be anyone who is around the borrower and knows him, and the bias of the truth of common friends' words is also reduced in this way.

Similar to LM2 and LM8, LM9 also considers that if all the people asked speak well of the borrower, their opinions are positive, then the borrower should be good, normally. While if not, which means CFs speak ill of the investigating target, then LM9 may re-consider the lending and it may affect the final lending decision. In addition, it can also be seen from LM8's quote ('know in our heart') before that the way distinguishing whether the CFs are telling the truth or not is very subjective, meaning there are no formal rules or standards to evaluate it. As LM2 said, *"it is just a kind of reaction or judgment from the chatting"* (LM2: Transcript 2, P.9). LM9 explains this "judgement" in detail,

> "For example, if you are speaking ill of him, then I will think about your character. If you are a petty guy (who likes to hold a grudge against someone else) in daily life, then the reason you speak ill of him is that you may have a conflict with him. If you are a fair person in daily life, when you are speaking ill of him, I will also sense your intention or purpose through your tone and facial expression, I will have a feeling about you. In this way, I will distinguish what is true and what is not completely true. (LM9: Transcript 9, P.6, 7)

So the salient point here is that LM9 will also try to evaluate the CFs; he will judge if they are telling the truth or not, and their motives for doing so. For example, if the 'common' friend's motive is bad, which means the only reason he speaks ill of the investigation target is because that they had a conflict, then LM9 may ignore it. LM9

will even judge if the CF is telling the truth or not through his tone of voice and facial expression. I think this is the most interesting point here. LM9 is like a policeman who is investigating criminals, but this method does work in China. So the measurement of the truth of the common friends' words all depends on the LM's evaluation and judgement, which also show the importance of the LM in the lending process.

6.5 Summary

As it can be seen from this chapter, one function of *guanxi* is that it can be used as a tool to develop and maintain customers, and when LMs in China use it as a marketing strategy, they should remember to follow some informal rules. This means there are some informal rules which act as a kind of lubricant to smooth the establishment of *guanxi*. For example, Chinese people would consider that it is too 'cold' and de-humanised to discuss business directly when they first meet, particularly if they are not quite familiar with each other at that time. Therefore, in these circumstances, they will use informal ways such as chatting about other things that people would be interested in first to make this process more comfortable, 'warm' and humanised. At the same time, the *xinren* or trustworthiness between the two parties is improved in this way, and finally *guanxi* is also improved and established in this way. So, this is an informal rule of how to establish *guanxi* with Chinese people and it has been in the Chinese bones and genes for centuries. The quotes in this chapter show that this informal rule is also applied in the SME-bank lending domain. Besides, the findings show that the maintaining of *guanxi* is through long-term and continuous interactions, which makes *guanxi* different from relationship under western context, since it may not for short-term and immediate returns.

The quotes in this chapter show that another function of *guanxi* is to control risks. LMs maintain the *guanxi* with SME managers by making friends with them. The findings also show that this 'friendship' probably does not mean they are true friends; LMs might just use this as a method to secure the safety of the lending. This is because from their standpoint, borrowers will share more internal information and be more frank with them if they are friends, so *guanxi* is more interest-oriented and safety-oriented on the LM's

side. One purpose of maintaining *guanxi* with borrowers is in order to get more internal information about borrowers, then estimate and control the risks using this information. While from SME manager's side, they could also secure loans and reduce policy uncertainties by making friends with LMs, since they can know bank policy changes which may affect the loans in advance through it. However, some LMs such as LM9 show that they will make true friends with SME managers as this responds to their needs as human beings, which is the human nature.

The third function of *guanxi* is that it can be used to investigate SME managers through 'common friends' (CFs) and *guanxi* circles. It can be concluded from this chapter that there are two types of 'common friend' (CF) *guanxi*, one is where the investigator (loan manager) knows the common friend directly; this type is known as direct CF *guanxi*. While another is called indirect CF *guanxi*, which means the investigator (LM) knows the common friends or a *guanxi* circle through an intermediary (i.e. his colleague). The only difference between these two types of *guanxi* is whether there is an intermediary to build the connection between the loan manage and the CF. The way LMs investigate SME managers through their CFs can be described as in following two simple models. A very simple and basic direct CF *guanxi* model with only one CF would be a triangle, each of them in the triangle has connection with the others and all of them form the whole circle. The CF should be a good friend of the SME manager, or be in the same industry, which means he should know the SME manager well. So the CF is someone who knows both the SME manager and LM, but who knows the former well, and better than the latter. It is obvious that the relationship between the LM and the SME manager is a lender and borrower relationship; the LM wants to investigate the SME manager. Hence, all their connections are based on the direct CF *guanxi* model, and the LMs could obtain information about the borrower from the CF directly. However, the indirect CF *guanxi* model could be like a prism; for example, the colleague (intermediary) is at the top point, the borrower is at the bottom point, the LM is at the left point, and the CF is at the right point. The relationships between the CF and the SME manager, the LM and the SME manager remain the same, but since the LM and the CF barely know each other, the *guanxi* strength between them is weak. However, they should at least know each other, so that the information can be transferred between them. This weak *guanxi*

is built upon their respective strong *guanxi* with the intermediary. Therefore, these two models are the foundation of a CF *guanxi* investigation.

In practice, LMs use various CFs to investigate an SME manager, and these CFs could be people in the same industry, friends, LMs from other banks, the SME's upstream and downstream enterprises, government departments, or even the SME manager's wife. In a word, anyone or any *guanxi* bodies related to the SME under investigation and with a close relationship with the potential borrower (the SME manager) could be CF here, since they are usually people or organisations in the same industry and know each other well. The findings also show that the LM will contact them and try to obtain as much information as he can about the target SME or the SME manager. We can see that there are also *guanxi* circles involved in this process and the whole procedure is called the CF investigation process of the SME or SME manager. The *guanxi* circle refers to people in the same circle who should know each other well, and it sometimes has the characteristic of exclusivity, which means people outside the circle may not be able to obtain the latest internal information. This will be discussed in the discussion chapter later.

The findings in this chapter also show that *guanxi* is not only an informal rule but also social capital in China, and as social capital, it can bring some benefits to SME managers (as will be discussed in the next chapter). At the same time, it has a transferable feature. For example, in the CF investigation process, the LM can use his bank colleague's *guanxi*, and ask him to ask his customers to provide information about the potential borrower under investigation. This means that through the use of his *guanxi* with his colleague, and his colleague's *guanxi* with CF, the LM could also use the CF's *guanxi* with the potential borrower under investigation to obtain the information he wants indirectly. Hence, *guanxi* is transferred during this process. We will discuss in the next chapter that this transferable feature is not used only in the lending investigation process, but that some SME managers will also use it to obtain loans.

Chapter Seven: The role of *guanxi* in the lending decision

7.1 Introduction

Chapter Six is more about how *guanxi* smooths the way on the lending process. This chapter shows that it could affect the decision-making and there is also a clear negative side related to it. Besides, the presentation of this chapter is slightly different from the rest three empirical chapters, the previous chapters mainly just analyse and 'present' the findings, however, there are also some discussions involved in this chapter, which are connected to the theories or literatures. The first section in this chapter shows the importance of *guanxi* strength, a high level or strong *guanxi* could generate *xinren* (trust) between the participants, which means that is easier for acquaintances to obtain loans from banks than it is for strangers, since loan managers (LMs) would have greater trust in borrowers they were acquainted with. This is one aspect of the effectiveness of *guanxi* in the lending process. The second section explains another two important dimensions of *guanxi* apart from the *xinren* (trustworthiness): *renqing* and *ganqing*. The findings show that these two elements also play an important role in lending as manifestations of *guanxi*. The third section continues the topic of gift-giving which derives from the *renqing* and shows that it is a tradition in China but could become dark when this behaviour is abused. The last section provides detailed examples from the research data and shows precisely how *guanxi* could affect lending, also indicating the importance and direct impacts of *guanxi* on lending decision making.

7.2 Acquaintance *guanxi* could generate *xinren* (trust)

Acquaintanceship [13] is a high-level *guanxi*; clearly, the *guanxi* strength between acquaintances is higher than that between strangers. In the area of bank-SME lending, it is also better if SME manager and LM know each other well as acquaintances rather than as strangers. Start from talking about loan mangers, the following example explains

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[13] Note: Granovetter defines the relationship between acquaintances as a weak tie, and that between friends as a strong tie (Granovetter, 1973: 1368). However, acquaintance *guanxi* in this thesis is defined as a strong tie. Details will be presented in the discussion chapter.

a little of why acquaintances are better than strangers in obtaining loans.

> **ME: *Ok, so you mean the change or replacement of loan manager will affect the lending?***
> **LM4:** Definitely.
> **ME:** *Why? What is the reason?*
> **LM4:** It is simple. **In China, we would rather do business with acquaintances than with strangers.** Your vigilance will be higher when you are dealing with a stranger, right? And we are not able to get to know someone well in a very short period of time. The enterprise's operating condition is only one factor; another very important factor is the manager's character. This cannot be done in just a few days of time, it is a long process. (LM4: Transcript 4a, P.8)

The above conversation is an extract from the interview. Before this conversation, we were talking about the duty of LMs. LM4 said many careless LMs just treat their customers as a way to make money. They might work in this bank today but work in another bank tomorrow, so they just grant as many loans as possible when they are in this bank but do not care whether the borrower could get a continuous loan or not after they leave. Normally, if a LM has previously granted a loan to a SME manager, then he should have investigated him and know this borrower well, so their *guanxi* level should be higher than that of strangers (i.e., a new LM and this borrower). Hence, they probably even lower the requirements for granting the loan since their *guanxi* is good. But once the LM is replaced, the new one may not know the customer and his circumstances well,

> "… so mostly, the customer will not get the loan again after the previous customer manager leaves. This is the real situation; many enterprises go bankrupt due to this."
> (LM4: Transcript 4a, P.7)

The cash flows of SMEs are always limited and if they cannot get sustainable loans, they will face liquidity problems and may go bankrupt. Apart from it, LM4 also gave another reason for this being the case, which is the new LM's own considerations.

> "It [the previous lending] was not his business before, so he does not care about it.

If he continues the lending and something bad happens, he has to take full responsibility for it. But if he does not continue it, then the bank will ask the previous customer manager to be responsible for the problems, and it is none of his business. They will be conscious of this." (LM4: Transcript 4a, P.8)

Hence, the new LMs will think about themselves but not the borrowers because they are afraid of the risks that come with the uncertainty of the borrower, as they do not know the borrower well. The conversation continues,

LM4: This is what I always say: **we prefer to do business with acquaintances rather than strangers.** If we know the customer well and he is able to raise money in a short time, then it is safe to give him the loan.

ME: *So it is through long-term cooperation and understanding?*

LM4: We cannot trust (*xinren*) him if we have known him for only a very short time [interaction]. (LM4: Transcript 4a, P.19, 20)

As we can see from the above quotes, acquaintance *guanxi* is built through long-term interactions, which could generate trust between the participants. If two people are acquaintances, then it means their trust level is comparatively high. However, a new LM and a borrower are strangers, which means the new LM is uncertain about the customer and does not trust him since they do not have good *guanxi*, and hence he does not dare to continue the lending. Thus, the borrower may not obtain the loan any more after the leaving of previous LM. This phenomenon also shows the importance of *guanxi* in the lending process; to a great extent, the lending is not based on the bank's formal lending system, but on their *guanxi*. If this were not the case, then a previous LM's departure would not change the lending, but the fact is that it does, confirming the suspicion.

In order to dig deep about the acquaintance *guanxi* in SME lending, I asked the following question in the interviews:

ME: *Well, for example, let us say there are two tenants in the market, and both of them want to apply for a loan from you. One may be a bit more familiar with you,*

while the other is not so familiar. Would you be more willing to lend money to the one who is more familiar? Or to lend him more?

LM5: Well, there is a premise. It depends on what their businesses are like.

Me: *Both the same.*

LM5: If they are more or less the same, then I will lend to the one I am acquainted with, since I trust him more and he also trusts me more. It is very simple […] because we know each other's background well. If we are not acquainted with someone, we need to investigate his condition gradually, to know what he is like and what he is doing; it takes time. So from the efficiency aspect, it is faster [lending to an acquaintance]. From the revenue aspect, we can also earn more [from an acquaintance], because he trusts you, and if he believes in you, he will not care even if you are more expensive; it doesn't matter, right? And a trusted, acquaintance, what else can he bring to you? Later cooperation. For example, he will open an account in your bank later. And if he trusts you, he will call you if people around him also want to do business with the bank. (LM5: Transcript 5, P.20)

Thus, some of LM5's opinions about lending to acquaintances are similar to LM4's, as he considers that there are three benefits of this lending to acquaintances. The first is it is faster to lend to acquainted borrowers since they know them well and do not need to take much time to do the investigation, so the investigation and negotiation cost is lower and more efficient. Second, acquaintance *guanxi* is not just for one lending transaction only, but also for further cooperation. This also concerns the function of *guanxi*, and it was already shown in Chapter 6 that *guanxi* could be used to develop new customers, and which could reduce search costs for the bank. Third, once the borrowers are locked in this *guanxi*, then they will not care about paying more interest since they trust this LM more than others. He gives an example to explain it,

"Take our president as an example; he has been maintaining our longest customer for about six years. This is just like doing business, it is quite stable if you have a customer for more than three years, your customer will not go to another bank just for a lower loan rate. Why? Because the success rate [of obtaining a loan] is higher if seeking an acquaintance. He will not want to try a new bank since it will not bring him any sense of safety. […] he will consider that I am more reliable, or I am

more considerate of him; there is no doubt that he will come to you, regardless of the difference in interest." (LM5: Transcript 5, P.13)

LM5 considers that long-term acquaintance *guanxi* could bring the borrowers a sense of safety which is built upon trust between the participants. In turn, this trust could also bring the bank more profits since the borrowers are locked in this *guanxi* and trust. When I asked LM7 the same question, he answered,

"This is definitely a very important factor, of course we will attend to the acquaintance first, because you know him better, right? The risk is quite high nowadays, and actually I think the reason why it is high is that we do not know (our customers); the hidden risk is the biggest risk. If we know he is of high risk, we will figure out a risk prevention measure, but the unknown risk is the most dangerous." (LM7: Transcript 7, P.8)

Therefore, LM7 has a similar opinion to LM4, and the reason why he also prefers acquaintances is that he is uncertain about strangers, and the risk of making loans to strangers is not controllable, corresponding to LM4's words before. Compared to LM4 and LM7's concern about risk for the bank, LM5's quote before shows that concern is mutual. SME managers are also afraid of not being able to obtain funding from LMs they are not acquainted with. These fears add to the calling of trust among acquaintances, probably regardless of the costs. However, these statements are all from LMs, so I asked EM5, who is from a medium-sized manufacturing enterprise, the following question:

ME: *Is it easier for you to get loans from the banks that you have been cooperating with for a longtime?*
EM5: That should be the case; the cooperation process is also the process of knowing each other, the more you know each other, the greater the trust between you. The bank also knows our enterprise well [during the process], including the understanding of our management operation, our customer base, […] and they are also more familiar with our top managers; in that case, our top managers also would like to cooperate with the bank. (EM5: Transcript 13, P.2)

As can be seen from the quotes, EM5 also considers they have advantages in obtaining loans from LMs they are acquainted with, since a better understanding of each other during the lending interactions could generate a greater degree of trust, which is very important in obtaining a loan. Thus, his statement is quite similar to that of LM4, LM5 and LM7. Another SME manager, EM7 made it clearer.

"…there is difference between acquaintances and strangers when you are applying for a loan from bank. Some banks may consider your risk is high after the investigation and will not like to lend, while a bank you are acquainted with may still make you the loan, this is the difference." (EM7: Transcript 15, P.16)

Thus, it is identified that, from the standpoint of SMEs as well as banks, acquaintances are also better than strangers in terms of obtaining loans, and EM7's saying above shows an acquainted *guanxi* would even let the bank reduce its safety assurance, regardless of the risks. When I asked LM2 the same question as LM5 and EM5, the answer was confirmed and he explained a little about why acquaintance is an advantage,

LM2: The *xinren* (trust) degree will be comparatively higher.
Me: *Can you give some examples?*
LM2: For example, if you have a long cooperate *guanxi* with me, and your other banking businesses like deposit saving and wage payment are also going through our bank, then we will have a better understanding of you. We can estimate your enterprise's condition through your capital flows in our bank. We have provided some small credit loans to several enterprises under these circumstances before; they do not need to provide any collaterals or other things, **but only because that they have a long cooperate *guanxi* with us and they have accumulated enough credit records in our bank.** […] As long as your enterprise's operation is stable, you do not have any bad records and the firm's industry has good prospects, then there will be no problem in making the loan. (LM2: Transcript 2, P.10)

From LM2's statement, we can see that *guanxi* is not just about the 'ease' of obtaining a loan, but also about the availability of a loan without any collateral. It is

known from the research data that the two main lending techniques in China are collateral lending and guarantee lending; and there is rarely any credit lending. However, this bank provides some small credit loans to those enterprises who have good *guanxi* with them, without providing any collateral or anything else, as their banking business is also going through the bank. Since the bank knows the enterprise has the capacity to repay the loan, so the risk is low, and it can undertake lending in this case. It is also a kind of information rent-seeking behaviour in fact; if the firm has a longer cooperate *guanxi* with the bank, then the bank has the opportunity to obtain more internal information about the enterprise, which can reduce the bank's risk. It can also help SMEs to obtain extra 'benefits', the enterprise could secure a loan which could not obtain in the past, or obtain it more easily by providing more internal information to the bank in the way of long-term *guanxi*. Which will be discussed in Chapter 8 later.

In conclusion, it is found in this section that acquaintances have more advantages than strangers in credit availability, since acquainted *guanxi* could generate trust between the participants, which could bring sense of safety and reduce information asymmetric problem, such that banks may reduce some lending requirements of acquainted SMEs. Besides, it could also reduce investigation and negotiation costs for banks, and search cost for SMEs.

7.3 *Renqing, ganqing* and 'gifts'

When talking about long-term *guanxi*, *renqing* arises as an inevitable element, particularly among acquaintances. The definition of *renqing* has already been discussed in the literature review chapter. It is a very important dimension of *guanxi*, and it is also a manifestation of the *guanxi* between LMs and SME managers in the banking-SME lending area.

According to Hwang's (1987) first definition of *renqing* (Chapter 2), people who know *renqing* should be empathetic, understand the other person's emotion and try to respond appropriately to them. As EM2 said.

"If he [the loan manager] always considerate of you, but has no additional requirements, then you will have a feeling [*ganqing*] towards him; this process is *renqing*. When there is *renqing*, then for similar products, I will choose them from him, but not from others; that is the result, and this is *renqing*." (EM2 and EM3: Transcript 11, P.10, 11)

Last section mainly discusses how LMs like to make loans to acquaintance borrowers, but from this quote, we can see *guanxi* has the same effect on SME managers. After *guanxi* is established, and when *renqing* exists between the two parties, SME managers also like to borrow from the LM who has *renqing* with them, but not from others. This is the power of *renqing* and *guanxi*. Hence, the SME lending is a two-way selection process, as when LMs choose SME managers, SME managers also choose LMs, and the selection standard in this process is the quality of *guanxi* or *renqing*.

Hwang (1987, p.954) considers that "*renqing* connotes a set of social norms by which one has to abide in order to get along well with other people in Chinese society." In addition, as EM10 said,

"*Renqing shigu* has existed in China for quite a long time; it is a tradition. China is a country of ceremony and propriety, and although it may bring some disadvantages like corruption, it is embedded in the Chinese culture. When people get along with each other, no matter whether they are from banks or SMEs […] they will talk about *ganqing* at ordinary times mostly. But it also depends on yourself. Some people like money, some like luxury goods, while others may like to be highly admired, for example, they want people to visit them often, to come to their office and chat with them, they may not need very expensive gifts but respect and *ganqing*. But when people interact with each other, no matter who, you can only get along well with each other when you have 'needs' from each other. In modern society, people will come and socialise with you only if you have 'value in use'. For example, if you are useful to me, then I will make use of you. The word 'use' may not sound pleasant, but it is the real word. However, if you do not have 'value' to me now, but I still come to see you regularly and respect you, which makes you think I am [nice]… then in your heart, you will have *ganqing* with me.

You will help when I am in need in the future, this is the situation." (EM10: Transcript 18, P.13, 14)

Guo and Miller (2010) translate *'renqing shigu' (人情世故)* as social etiquette. Ruan (2017) translates it as *renqing* and sophistication. However, I prefer to translate it as the operating or the operation of *renqing* here; it can be either a verb or noun in Chinese. As we can see from the above quote, *renqing* has had resonance in the Chinese tradition since ancient times; it is a cultural custom in Chinese society. *Ganqing*, another element of *guanxi*, always comes together with *renqing*. Sometimes, the word *ganqing* could be replaced by *renqing* in Chinese nowadays, there is no clear boundary, but *ganqing* is more about the "feeling" while *renqing* emphasises more on the "process". It can also be seen from the above quote that *ganqing* is improved through frequent social interactions, and in order to maintain their *guanxi*, LMs and SME managers should always keep in touch with each other by visiting from time to time, exchanging gifts and so on. This process is *renqing shigu* in the banking industry. We can also see from the quote that in modern times, as society has developed, *renqing* or *guanxi* have also evolved from a social phenomenon into a kind of transactional approach, a social capital and some people use it only as an instrumental tool, ultimately to gain profits for themselves.

Gifts play an important role as a lubricant for improving the *ganqing* and *guanxi* between SME managers and LMs. As EM4 said,

> **"**Eh…about gift-giving, I think during Chinese New Year or other festivals, I think it is a way to show your regard and is also an important way to strengthen the bonds of your *guanxi*. It is not about the value of the gifts; it is a tradition inherited from our ancestors." (EM4: Transcript 12, P.10)

Renqing can be transferred between people, and sometimes the exchange of *renqing* is realised by an exchange of gifts, with *ganiqng* and *guanxi* being improved in this way. Hwang (1987) defines *renqing* as a kind of resource in social exchange, and normal *renqing* exchange through gift-giving has been very common in China since ancient

times. LM7 consider gift-giving as a part of *renqing* is also very common in the SME-bank lending, but its nature has changed considerably in the banking industry. As EM10 said,

"… You should send something proper, like gifts, because it is him who lends you money to do the business, so when you are making money, you should also send a little bit of the benefits, you should give some sweets to him under the right circumstances. For example, when we are going out having meals with a loan manager, I will definitely not let him pay the bill, right. Then when he sees you are a man knows *renqing*, he will be more willing to help you after the meal. If you do not meet him regularly, and have no gift for him, then why would he want to give you the loan? Right? Only by saying, 'oh, I do not have enough money, please lend me some'? No one will care about you. If you two have common interest *guanxi*, or *ganqing guanxi* between each other, either is enough, he will definitely help you then." (EM10: Transcript 18, P.14)

When people all think like this, the general mood of the whole industry changes. Some people just use this kind of behaviour to achieve their own purpose nowadays. SME managers use it to obtain loans, bank leaders use it to maximise their own interests, and LMs can also use it to gain more income, so that negative things such as corruption emerge. The conversation continues:

"What we Chinese call *renqing*, or *guanxi*, ok, or say it in another way, giving gifts at Chinese New Year or festivals. To be honest, loan managers do not have high salaries generally, but if he has twenty customers, let us say and each of them gives him one or two thousand Yuan on the Mid-Autumn Festival, then that would be tens of thousands [CNY], right? He can get tens of thousands at just one festival, and this is his own income actually. So when you are doing this *renqing* activity, he should also pay back some *renqing*, right?" (EM10: Transcript 18, P.7)

As it can be seen from the above quote, an obvious incentive for LMs to participate in this activity is that it can bring additional and larger incomes than their salaries, so their attitude is, why not? When the LM receives some 'gifts' from the borrowers, the

way how he pays back this *renqing* is to help them obtain a loan, which makes it a kind of social transaction or exchange in fact. EM10 used a metaphor to compare SME lending with normal money lending between individuals, which also shows how *renqing* or *guanxi* works in the lending process,

> **EM10:** It is just like we are borrowing money in our private lives. When I do not have money, [I may ask], "please lend me fifty yuan." If we do not have *guanxi*, you may just answer directly, "oh, I do not have any money either." But if we do have *guanxi* and *reqning*, it is shameful for you to say no. Maybe you do not have fifty to lend out, but you would still give me twenty.
> **ME:** *So this (process) is a kind of renqing?*
> **EM10:** Yes, *renqing*. (EM10: Transcript 18, P.15)

The above simple example indicates the nature of *renqing* as a kind of social capital. If someone has a good *guanxi* with you and pays you *renqing*, then you should pay it back, otherwise, you will feel ashamed, as this is a common view in Chinese society. However, if you do not have *guanxi* with him, you will not feel any guilty if you reject his request. So this is where *renqing* plays a role and why many LMs are willing to help borrowers to obtain a loan after receiving *renqing* or gifts from them. The next section mainly discusses how this 'exchange' works, as well as the dark side of *guanxi*.

7.4 The dark side of *guanxi*: boundaries between legal and illegal gift-giving?

As discussed in Chapter 4, the commission LMs can get from the bank is legal, and, as shown in the above section, normal gift-exchange or *renqing* exchange is also a tradition in China. However, EM10 also provides an example of an illegal practice, bribing LMs:

> "Some bad loan managers, usually aged over forty, and who rarely get any promotion opportunity in the bank will try to collect as much money as they can before retirement. Let us say the loan amount is one hundred thousand CNY, then the loan manager may get ten thousand or five thousand CNY from the borrower after the loan. This situation does happen, and these people are very bad." (EM10:

As can be seen from the above quote, there are some corrupt LMs who take bribes from SMEs. They will help the SMEs to obtain loans and they will receive 'bonuses' from the enterprise once the lending is concluded. The 'bonuses' in such cases are similar to the kickback or brokerage concept in the marketing field. In this case, 'loans' can be treated as a kind of rare and unique good which is in high demand in the market, so not all the customers are able to 'buy' it. LMs are the salesmen of this 'good', so the customers will bribe the salesmen in order to get the 'good'. Banks are in fact 'selling' loans. But from the SME side, which kind of borrowers will bribe LMs and how?

> "Those [SME managers] who are begging for loans, they will pay great attentions to loan managers, giving them gifts, treating them to meals and entertaining them, because they are afraid of not being able to get the loan." (EM2 and EM3: Transcript 11, P.8)

So unqualified borrowers, those SME managers who are in desperate needs of funds but not able to reach banks' requirements, who are not able to obtain the loan through formal lending procedures, they would bribe LMs, and ask them to help increase the possibility of getting the loan. After they have used *guanxi* to obtain the loan and the shady transaction is made, they will offer a certain amount of money to these dishonest LMs, and as EM10 said, this amount might be five to ten percent of the loan amount. Giving small gifts may be legal and common in China, while large amounts of transmission of interest between bank officers and SME managers also happens. EM10 talked about this kind of corruption in detail during the dinnertime talk.

> "If the loan amount is 2 million CNY, then maybe 100,000 or 200,000 CNY is given to bank leaders from the borrower in various ways, especially if the borrower is not able to get the loan with formal requirements." (EM10: field notes)

EM10 revealed another very important piece of information: not only did some LMs help unqualified borrowers to obtain loans, but some top leaders from the bank were

also involved in bribe-taking. He pointed out that the reason why some top officers in banks are rich is that they can get interest (or bribes) from borrowers after the lending, and the amount is quite large. 'Various ways' means the bribes may not be given only in the form of cash or money, but also in other forms such as expensive gifts, vouchers and so on. This was also confirmed by EM4,

> "The help from loan officers [loan managers] is limited, because their power is also limited. But maybe through some top leaders like the president of the bank, the success rate is much higher." (EM4: Transcript 12, P.10)

So EM4 considers that top leaders have more power to affect lending. Although EM4 did not provide any precise facts or examples in his interview to prove this saying, other interviewees (i.e. EM3, EM10 and LM7) revealed some facts in their interviews; for example, LM7 said bank leaders could persuade credit review approvers to approve the loan. We cannot say everyone in the bank is taking bribes, but from EM4 and EM10's words, at least some people in the bank have taken bribes for their own interests. More importantly, LMs know there was widespread corruption. LM9 from the bank side also confirmed that bribe-taking was happening in banks and that previously, the situation was extremely serious:

> "In recent years, especially 2008, 2009 and so on, which were the best years of banks in China, it was a common phenomenon in the whole banking industry. Everyone was doing this [offering and accepting bribes]. If you did not do this, you were anti-social and people would be wary of you. (LM9: Transcript 9, P.8)

LM9 pointed out that the situation was quite outrageous before; bribe-taking was a kind of unspoken rule in the whole banking industry, and it seems that most LMs accepted bribes at that time. The situation was that if SME managers did not offer bribes, they might not be able to obtain the loan. In addition, LMs who did not accept bribes were even considered to be anti-social and would be isolated by their colleagues at that time, so perverse was the situation. The situation may have improved now, as EM8 said,

"If you have personal *guanxi* with the bank president, then it is more convenient for you to get the loan, this situation did exist before. But since 2013 and 2014, all the lending authority has been moved to the upper branch, which means it is harder for you to get the loan even if you have personal *guanxi* with the bank president. However, alas [he sighed] … from the aspect of getting loans, through certain personal *guanxi*, perhaps, you may still get some support, but not that much. (EM8: Transcript 16, P.2)

As we can see from the above quote, although EM8 said the situation was better now, he did not completely deny the existence of this phenomenon, implying that *guanxi* with bank leaders in the form of bribe-taking may still affect the lending currently.

LM9 and EM10 were familiar with me, so they were completely frank and open and would use the words 'corruption' or 'bribes' directly. With others who were less familiar, I asked them in a less direct way, using the word "gift-giving" rather than "bribes" during the interviews, because "gift-giving" does not necessarily mean corruption, and normal gift exchange is very common in China. I thought they would be more comfortable with that, as bribery and corruption are very sensitive topics in China. However, their responses showed that they understood what I meant. When I asked EM7 whether 'gift-giving' was a kind of 'unspoken' rule in the whole banking industry, he said,

"Of course, it does exist in Chinese society, but it is not allowed by the regulations or law, hahaha… However, forbidden does not mean it will not exist, there is another system of *guanxi* (apart from the regulations). So many deadbeats, who get loans from banks and evade their debts, how? Because many of them just use *guanxi* to get the loan. So personal *guanxi* does exist and work in the whole financial market. (EM7: Transcript 15, P.7)

It can be seen from the above quote that even if the regulations or law in the bank forbid bribes, some dishonest SME managers can still use *guanxi* by sending bribes to obtain the loan. I asked LM3, who is from a city commercial bank, similar questions. He replied as follows:

"It may happen in other banks… this thing is hard to say, but in my opinion, I do not like it. (LM3: Transcript 3, P.14)

Obviously, LM3 knew that it ("gift-giving" or bribe-taking) is not a good thing and does exist in the banking industry, but since he was not familiar with me (LM3 was introduced by another interviewee through normal snowballing method and that was the first time I met him), so he did not trust me and would not like to talk much about it. However, he did admit that "gift giving" would affect lending when I asked the following question before that:

Me: *Do you think it* ("gift-giving") *affects the lending decision? Maybe not in your bank, but in others? Will it affect other banks' lending decision-making?*
LM3: If they accepted [gifts], how to put it, if they have accepted things like this, and these activities did exist, then it should be affected. (LM3: Transcript 3, P.13)

On the one hand, we can see that LM3 is trying his best to show that he has no correlation with bribe-taking: he has denied more than three times in the interview that it (gift-giving) exists in his bank, and he is extremely disgusted with it. It is obvious that he wants to make himself clean and exonerate himself from any dishonesty, while, on the other hand, he admits that gift-giving happens in other banks and will affect their lending decision-making. His reaction of both denying and admitting also tends to confirm my suspicion. EM3 reacted in a similar way when talking about this during the interview:

"Some of my friends are bothered that it costs a lot of money to entertain people from banks with dinner or activities like singing karaoke. But we never have this kind of treatment [towards bank officers]." (EM2 and EM3: Transcript 11, P.6)

Both LM3 and EM3 deny that 'gift-giving' or bribery happens with them, but only with others. Perhaps they wish to avoid any trouble by denying it, since if they admit it, then it means they are also guilty, so they protect themselves by saying this. At the same

time, they both have a clear picture of the situation regarding bribery, since both of them admit that this phenomenon does exist. This phenomenon (i.e., the interviewee denies bribe-taking behavior but admits it happens) also occurred during the interview with EM4.

> **EM4:** But I think if you want to get some 'bonuses' from sending out gifts, it is unrealistic. Because the gifts we send out are not that valuable; it is just a tradition, courtesy demands reciprocity. If I want a loan, I will never try to get one by sending out gifts, as for me, it has never happened in my place. I always think that your enterprise should be strong in itself.
> **ME:** *So what about others?*
> **EM4:** I will not deny it does happen in others. (EM4: Transcript 12, P.10)

EM4 strongly affirmed that he has never tried to obtain a loan by offering gifts. However, another two interviewees (EM7 and EM8), who know him well, refuted his words indirectly in their interviews. I did not even ask them about this directly; they just revealed this information to me by themselves and in front of EM4, which means it is not a secret to them. Indeed, EM4 introduced EM7 and EM8 to me and accompanied me to meet them. During the interview with EM7, when I was asking questions about gift giving, EM7 said that I should ask EM4 about this since he is very good at it.

> "He has more connections with banks than me now. About the gift-giving or *guanxi* you mentioned just now, it suits him (EM4). He is first-rate in *renqing shigu*; he is very expert in it." (EM7: Transcript 15, P.18)

Besides, during the interview with EM8, he revealed naturally that EM4 always complained to him that it was really tiring to treat LMs to meals or other social activities, which also contradicts EM4's previous words. In addition, EM4 also mentioned that the possibility of obtaining a loan was stronger by bribing top leaders in the bank rather than LMs, indicating that he was clearly aware of how this system works. However, EM4 himself denied using *guanxi* to obtain loans from banks. One explanation for this behaviour is that perhaps, like other interviewees, EM4 also wants to protect himself, or due to other considerations, he did not tell me the truth, which was later exposed by

his friends. I do not think both EM7 and EM8 were telling lies, and they simply revealed the information naturally, without having been asked. Regardless of identifying the truth, a more interesting point here is that this process (EM7 and EM8 told me about EM4's situation) is very similar to LMs using 'common friends' (CF) to investigate borrowers. I am just like a LM and using a LM's logic to investigate and analyse EM4's personality here. I believe this could also be a very good example of how LMs use 'common friends' *guanxi* to investigate SME managers. Through EM7 and EM8's words, we can see clearly what they perceive EM4 to be like. However, to return to the topic, overall, as we can see from previous quotes, LM3, EM3 and EM4 all admit that some SME managers do use 'gifts' to obtain loans from banks, and that this situation exists in the industry. There were also other interviewees who were more frank with me. LM5 from a city commercial bank told me that:

> "As far as I know, maybe I can tell you about this, no problem. One loan manager, who is from another bank, and he was also my classmate, since he smokes, he accepts expensive cigarettes or wines from his customers. […] The situation of gift-giving does exist, but it has reduced a lot, it is not like old times. (LM5: Transcript 5, P.22)

LM5 gave a recent example to show that "gift-giving" still exists in the banking industry. I believe the boundary between legal and illegal gift-giving is if the value of the 'gift' is higher than their salaries, and this is done on purpose. LM9 gave an example to explain this boundary in the interview: when one of his customers got married, LM9 would give him some money, such as 1,000 CNY since it is a cultural tradition if he is invited to the wedding. If when LM9 got married, the customer would send around 2,000 CNY as a return for the previous *renqing*. LM9 would consider this is a normal *renqing* exchange in China and one which corresponds to social norms. However, if the customer uses this custom as an opportunity to offer bribes, like sending 20,000 CNY, and asks to obtain a loan, then LM9 considers this is as bribery. LM4 also has similar opinion, that if the cash gift is more than 10,000 CNY, then it is not appropriate. Yau *et al.,* (2000) define gift-giving bribery as someone who uses it to affect rational decision-making and with an objective of gaining advantages in economic activities. So this is

the boundary between legal and illegal. In addition, I think the "old times" in the above quote is similar to what LM9 said previously, referring to 2008 and 2009, during which times bribe-taking was quite common in the whole banking industry of China.

After the interview with LM7, I encountered EM5 in LM7's bank, so I had another brief, extra interview with EM5. The interesting point here is that when I saw EM5, he was just taking some gifts [they appeared to be wines] by hand to LM7. In order to avoid embarrassment, I omitted questions about 'gift-giving' during the interview because that he was just giving gifts to the LM at that time. I think if I had continued to ask such questions, he would be in a very awkward position, so I did not ask any questions about 'gift-giving'. Instead, I asked questions about dinner invitations, which can be another kind of 'bribe'. EM5 replied,

> "We will still have dinner together, but it is rare nowadays. […] It is quite different from before. Besides, my opinion is that the enterprise's strength should always be the priority, this is the most important thing. If we depend on that tricky thing (obtaining funding through things like dinner invitations), then we will not able to survive in the bad economic environment; we will go bankrupt immediately when the economic condition is bad…" (EM5: Transcript 13, P.4)

Through EM5's words above, we can see that he understood that I was asking, not only about normal dinners, but also about the ones that SME managers treat LMs in order to obtain funding. The reason I am saying that EM5 understood me is that he considers dinner treatment (or bribe as truly it means) as a "tricky" thing; he thinks that it is not sustainable to do this (SME managers offer bribes and then banks grant the loan). He considers that the enterprise's strength is more important than bribery activities such as dinner invitations. LM7 told me in the interview that EM5 was very successful in operating his enterprise and his enterprise's condition was very good. So maybe from EM5's point of view, it is cheaper to do things legally if his business is successful. The interesting thing is that at that time, he himself was also bringing the gifts when I saw him, but maybe it was just normal *renqing* exchange. Probably, EM5 is also like LM3, EM3 and EM4 quoted above; he may also want to protect himself by

164

saying so. In addition, EM5 also mentions in the above quote that dinner invitations are rare nowadays compared with the past, which means this phenomenon was previously common, which also corresponds to other interviewees' words, such as LM9 talking about the bad situation in 2008 and 2009. EM6 also thinks the current situation is better, but when I asked the following question later:

> **ME**: *Do you think "gift-giving" is one determining factor of lending decision?*
> **EM6**: It is the same as before; those people who want money [loans] may act boldly, they will bribe anyone, it is still the same. […] It is definitely [a determining factor], and I have heard about a lot of these things." (EM6: Transcript 14, P.13)
> **ME**: *Can you give some examples?*
> **EM6**: There are a lot, eh…
> **ME**: *You do not need to give the names.*
> **EM6**: it is hard to say… (EM6: Transcript 14, P.13)

As can be seen from the above quotes, EM6 thinks that "gift-giving" is definitely a determining factor that can affect lending decisions, both in the past and currently, and he knows many people who are doing this. However, EM6 did not wish to share any specific examples with me, perhaps because that was the first time I had met him and he did not trust me, so in order to protect himself and others, he refused to share anything, as other LMs had done. However, it was also confirmed by LM9 that "gift-giving" can affect lending and he explains the reason for this:

> "Of course it will. Once you have received his money or gifts, the customer is in charge of you. If you do not grant him the loan, he has a handle on you, he can threaten you since it is against the law [if the amount is very large], it is bribe-taking." (LM9: Transcript 9, P.18)

This reason is important since it explains that bank officials are willing to cooperate not only because of *guanxi* and the interest they can obtain, but also because, when they accept bribes, they are bonded with the briber. Their fates are tied together after this. I think it is a common relationship between bribe-payers and takers, and the result is that,

"Many bank officials abuse their position or affect the credit review approvers after accepting bribes, resulting in bad loans." (LM9: Transcript 9, P.8)

As can be seen from the above quotes, bribe-taking does affect the lending decision. Many loans are made to unqualified borrowers and result in bad loans, so the risks are quite high for these lending transactions. However, these dishonest LMs are morally bankrupt and do not care about the risks, since it is not their money. This also leads to the emergence of more false statements, since SME managers know that these morally bankrupt LMs will still accept them and help them obtain a loan.

7.5 The role of *guanxi* in lending decision making

The previous sections present the manifestation of *guanxi*, the functions of *guanxi* and its dark side in the lending process. This section seeks to show precisely how *guanxi* affects decision-making in the real word.

When I asked about the impacts of *guanxi* on the lending decision, EM2 and EM3 said,

> **EM2:** "In previous years, you needed to rely on *guanxi* to get loans, because there were not many banks before, so the banks could make loans anyway. If your *guanxi* with them was good, they would lend to you, if not, they would not lend." (EM2 and EM3: Transcript 11, P.12)

> **EM3:** "It is obvious, depending on *guanxi*, [banks will lend] to those with good *guanxi*." (EM2 and EM3: Transcript 11, P.14)

It was shown in Chapter 1 that the establishment of modern Chinese banking system only began in 1995, and China did not have modern commercial banks until 2001. Therefore, there were not many commercial banks that could make loans in the early twentieth century, and it was very difficult for SMEs to obtain loans since the loan resources were so rare. Under this circumstances, banks were in the dominant position at that time; they could choose to whom they made loans, and, according to EM2 and

166

EM3, managers of enterprises who had good *guanxi* with the bank or LM could obtain the loan. However, EM7 has a different opinion about *guanxi* regarding large enterprises which are near bankruptcy and when the loan amount is large nowadays,

"For comparatively larger enterprises, when your enterprise is not good, will the bank save you just because of *guanxi*? It is hard to say. It is impossible for him to still lend to you, as the bank leader has his own responsibilities if the loan amount is very large. It is simple now, [when bad loans occur], the legal department of the bank will talk to you instead of the bank leader. The bank leader will avoid meeting you even if you two have a good *guanxi*; *renqing* is useless at that time. We need *renqing*, but it is best to use it when your enterprise is strong, otherwise, banks are not idiots and you are harming the bank leader if you insist." (EM7: Transcript 15, P.16)

Hence, EM7 held the view that *guanxi* might work in small enterprises, but not in comparatively large enterprises, and when the loan amount is large, as bank leaders might not help if the enterprise is not strong enough, since they have to bear great responsibility when bad loans occur. However, as seen from the last sentence of above quote, he did not deny the role of *renqing* in the lending, and still considered *guanxi* and *renqing* to be important. Although EM2 also considers *guanxi* has a less direct effect on current lending decision-making than it was in the past, he said another situation could still arise.

EM2: He will release the loan faster if you two have good *guanxi,* and slower if not. Then during the enlending period, many enterprises definitely do not have enough money, so they will borrow a bridging loan [to repay the bank loan], and the longer the time over which you borrow, the more interest you have to pay. If you have good *guanxi* with the bank, you [use the bridging loan to] repay the bank loan today and it will lend you it back again tomorrow. But some [enterprises who] have bad *guanxi* [with the bank], they repay the loan today, but the bank just keeps it for one week and lends it back after that. This situation also happens, and then they are screwed." (EM2 and EM3: Transcript 11, P.14)

As LM4 also mentioned in the pilot interview, the bridging loan means that when the bank loan is due, but the customer does not have enough cash to repay it at that time, then he has to borrow some money from relatives, micro-credit companies, or even from usurious money lenders. This bridging loan might only last several days, but the interest rate will be very high. After repayment of the bank loan, the bank will re-lend the loan to them again, and then he can use the bank loan to repay the bridging loan and the interest. This is called the enlending (*zhuandai, 转贷*) procedure, and will be discussed in detail in the next sub-section. Therefore, if the bank does not re-lend the loan fast, the enterprise needs to pay more interest for the bridging loan. The role of *guanxi* in this process is that it can affect the efficiency of the re-lending. It depends on the quality of the *guanxi*; better *guanxi* means you can obtain the bank loan back faster and pay less interest on the bridging loan. This is how *guanxi* affects one aspect of lending.

Furthermore, it was revealed by the interviewees that *guanxi* could still have an impact on the after-lending period. If there is something wrong with the enterprise, the LM will first report this situation and establish a risk pre-warning system, then he or she will gradually cut down the enterprise's loan, although there are some reasons why a LM cannot cut a loan immediately:

> "For example, if the enterprise has had a good *guanxi* with our bank for many years, or the SME manager has a good *guanxi* with our bank leaders like the president, then we will let our leaders discuss and decide [to continue with the loan or not] […] If the enterprise is in danger of bankruptcy, but the enterprise manager has many social resources to sustain it, then the leader may still consider lending the loan. Our bank leaders may have other considerations. For example, they will think about their own career development if the enterprise has a good *guanxi* with the government." (LM9: Transcript 9, P.4)

The above quote shows the importance of *guanxi* here: If the enterprise has a long *guanxi* with the bank or has a good *guanxi* with bank leaders, the loan will not be cut immediately; even if the enterprise is in danger of bankruptcy, bank leaders may still make the loan since the enterprise manager has *guanxi* to sustain it, the 'social resources'

mentioned refer to the resources that come with *guanxi*. So *guanxi* is one kind of social capital; for example, if the enterprise has a good *guanxi* with the government or the SME manager has a good *guanxi* with government officials, then the SME manager can use this *guanxi* to affect the lending decision. Why? Because, if the bank leader does not lend the loan, he has pressure from the government official and it may affect his interests, such as career development; therefore, the bank leader has to make the loan in his own interest. LM9 also mentions that many disqualified customers still obtain loans only because they have *guanxi*, and even if they might *"only have an empty shell, no factories and works, this situation may happen."* (LM9: Transcript 9, P.20) The following sub-section presents a specific example which shows how this *guanxi* affects lending regardless of other factors.

7.5.1 The importance of *guanxi* with local government: A real-life example

Wu (2008) used a semi-structured questionnaire survey to investigate 60 small businesses in China, and found that, "it is very surprising that relationships with bank or local government officers are marked relatively low in importance to the task of obtaining loans" (Wu, 2008: 968). This finding contrasts with my research finding that *guanxi* with bank officers or local government officers does affect lending decision-making. Wu (2008) used the word "surprising", which implies she herself has doubts about this result. She gives an explanation for the result but it is not entirely convincing. She mentioned that Confucian belief is the foundation of Chinese cultural architecture and presents some literature on why *guanxi* is very important in Chinese society, but she does not precisely answer the question why *guanxi* with bank or local government officers is of little importance in obtaining loans. In addition, it appears that there is a contradiction between her result and previous statements. The research findings in this thesis appear to support other researchers (Dunfee and Warren, 2001; Yen *et al.,* 2011; Yang, 1994; Lovett *et al.*, 1999), who had similar opinions that *guanxi* with government officials might be an important factor in a business operation. However, although they offered some explanations for this, there were rarely any empirical research findings to support it. In addition, Wu (2008) called for further, in-depth investigation into this area despite the uncorrelated result; thus so this specific example provided by LM9 could fill the gap.

In order to protect LM9 and for confidentiality, every piece of information which could be used to track the identity of LM9 has been deleted or replaced with acronyms throughout the entire thesis. Before the formal interview, LM9 and the researcher ate dinner together and we drank some wine during this time. In the relaxed atmosphere and since he knew all the people there well, LM9 was completely frank with me and was willing to share some sensitive information from the bank. The topics we discussed during the dinner were very interesting; for example, he talked about one of his customers who wanted to take a loan from his bank at that time. This may be an extreme example, but I believe it is not the only case in China which shows the importance of *guanxi* with government officials. *Guanxi* is not just about gift-giving or *renqing*; this example shows that *guanxi* as a social capital can also affect the lending instrumentally.

LM9 considers this 'bad' borrower is a liar and this transaction is like a loan fraud, because the borrower is actually doing nothing (as LM9 said, *no business, no factories, no workers, but only an empty shell*), and what the borrower provided (such as collateral and financial statements) actually did not meet their minimum requirements. The only thing the borrower has is a housing property collateral that is not worth much, and the real value of the collateral could not cover the loan. While one leader of the bank requires LM9 to help the borrower obtain the loan, and he must do so. One reason is that the bank leader has a good *guanxi* with the borrower; another reason is that the 'bad' borrower has a good *guanxi* with a very important local government official, and their *guanxi* is actually as close as real brothers. Some government officials have great power in China, especially in small places. As Robert (2017) said in a documentary film about China, *"In the past, Chinese law has been more vague, and more susceptible to the rule of individuals especially party leaders at local levels, who can intervene whenever they wanted to with the local judges or the local system, because those local judges reported to them."* (34"17'). Although he was talking about the legal system in China, it is the same in the banking system, and in this case, the government official can also easily have the bank leader lose his job since it is a state-owned bank and partially ruled by the government. As LM1 explained,

"The local government likes the government of […] place; it can convene all the bank presidents in the place to attend a meeting and command that they should not reduce the loans of relevant cooperate enterprises, which means if the bank has lent the enterprise 2 million CNY in the first year, and when the loan is due, if the enterprise has paid all the interest on time, then the bank must continue to make the loan in the second year. This is a kind of policy to help enterprises to get through hard times when the whole country's economic condition is not good. The government is afraid of that if banks reduce loans, enterprise may go bankrupt and many people will lose their jobs, which will cause employment issues and affect social stability. So this is a kind of protective action of the local government, an administrative command policy actually. From the aspect of administrative command, since most of the banks are state-owned, the banks have to follow the government's orders. Secondly, from the aspect of banks (whether state-owned banks or other commercial banks), since your banks are located here in this city, you should obey the local government and you need its support as well. Thirdly, the local governmental fiscal funds are deposited in different banks in this city. Every bank has some government deposits, the amounts range from fifty million to several billion CNY, so if one bank does not obey the government, the government can cut the deposit in that bank, which will affect the bank president's performance and also have an impact on the bank. These things are impossible overseas, so they are a kind of special characteristically Chinese phenomenon." (LM1: Transcript 1a, P.4)

As can be seen from the above quote, LM1 gave some reasons why the government can command banks in China; the government can affect the operation of the bank either from the policy level or the performance level, and it can require the bank to obey the rules or change their deposits in the bank, thus affecting the bank. Although this explanation is from the organisational level, it also explains why the bank leader has scruples about the government official in the above example from the personal level. In addition, the quote also explains that the government policy of supporting SMEs is the cause of the enlending (*zhuandai, 转贷*) phenomenon, as the government require banks to continue lending loans to those SMEs who do not have defaults. Thus, for example, if a SME has a loan which will expire at the end of the month, if the enterprise can repay

the loan, then the bank is required by the government to lend it back to the enterprise the following month. The precondition is that the enterprise has to repay the loan to the bank first. However, during this process, many SMEs might have invested the previous loan to buy equipment and so on, which means they do not have enough money to repay the loan first, so a bridging loan is needed and the enlending procedure emerges. The bridging loan means the enterprise has to borrow from a third-party financial institution and pay interest to them. Therefore, to return to this example, under the pressure from government official and considering his future career development, the bank leader has to help the borrower obtain the loan. As LM9 said,

> "The bank leaders will consider many factors and finally work out an appropriate decision. In this situation, we loan managers are not able to decide it. […] Our leaders will not go to enterprises to investigate by themselves, they care more about the management level things; so the only thing we can do is to report the truth and let the leaders decide." (LM9: Transcript 9, P.4)

As also discussed in Chapter 5, bank leaders have the right to make the lending decision. LMs are the first round of the whole lending process; their job is to collect information, sort materials, investigate the enterprise and find out if the enterprise is suitable for lending to. They have to ensure the security of the lending, and when problems emerge, they are on the front-line of coping with the borrowers, they have to be responsible for the issues. While the bank leaders, sometimes they may care more about management level issues, such as *guanxi* with government or the enterprise circles, their face, their status and so on. In order to maintain these, sometimes they may not care about the risks or the safety of the loan. If bank leaders insist on making the loan, LMs cannot do much even if the borrower's circumstances are not good.

> "We are not able to decide many things; we can only report the true situation. Unless you adhere very strictly to the rules of bank and do not follow the bank leader's order, you will reject the loan. You can do this and they can say nothing about it [since you are acting according to the rules], but you still want to stay in this bank, right? He is your leader and he can fire you if you do not follow him." (LM9: Transcript 9, P.15)

LMs have a limited amount of freedom when dealing with lending, even if the LM finds that the borrower is not good, sometimes they cannot reject the loan application, but have to follow the bank leader's order. If they do not follow them, they are at risk of losing their jobs. Hence, LM9 is in a dilemma as a LM, as on the one hand, if he provides the true materials for authorization, the credit review office will reject the application definitely. One the other hand, the bank leader forces him to help the borrower to obtain the loan. So the only thing LM9 can do is to provide false or modified materials for authorisation. As LM9 explained himself,

"You have to find a proper solution that will make everyone happy in the end. This is the most headachy thing in a Chinese bank; you are not just purely doing business." (LM9: Transcript 9, P.8)

Nonetheless, it is because of the *guanxi* between the bank leader and the borrower that leads LM9 to a dilemma. Without *guanxi*, at least in the above example, LM9 would probably feel it easier to do his job if everything was strictly in accordance with the bank regulations.It appears therefore that *guanxi* is much more important than financial and non-financial factors. If you have *guanxi*, you can obtain the loan even though you are doing nothing in terms of business. In addition, as LM9 has mentioned,

"The final decision is with our leaders; we just report the actual situation. But at the same time, you will have your own judgement and need a strategy. For example, if the borrower wants a 4 million loan, I will suggest reducing 0.5 million or 1 million. Then the leader will consider my suggestion and the final reduction may be only 0.3 million. The leader has his own considerations, for many reasons. You cannot go against your leader's decision; he has his own considerations and needs." (LM9: Transcript 9, P.7)

It can be seen from the above quote, that when considering the risks, LM9 may suggest reducing the loan amount in order to reduce the risk, but the leader may not let him reduce it by much since he might already have an agreement with the borrower for the loan amount. Thus, LM9 is caught in the middle, between the borrower and his

leader; as LMs, they have to be responsible for the security of the lending and the problems afterwards. However, at the same time, they do not have much power in the bank actually, but have to follow the bank leader's order. So what would he do to extricate himself from this situation? When LM9 has to disappoint the borrower (i.e. by reducing the loan amount by 0.3 million) to reduce the risks, he will do it in an indirect way and pass the buck to the CRD:

> "We may tell the borrower that it is the credit review department who reduced your loan amount due to some reasons, but not us. We are not able to change it since it is from the top." (LM9: Transcript 9, P.7)

It is a smart way to avoid antagonising the borrower for not obtaining the amount he wants, and the reason why the LMs act in this way is that:

> "We need to give our leader steps to go down [by doing this] since there are *mianzi* [face] and *guanxi* between our leader and the borrower. We also need to give the borrower *mianzi* [face] and provide him a nice and proper explanation [for the reduction of the loan]. Otherwise, he may complain to the bank president that I do not have the ability to do the business, or even talk about it in his *guanxi* network, 'we had a deal before that the bank will lend me 4 million, but finally the loan manager reduced the amount, he is dishonest.' This will affect my reputation in the bank and also in the enterprise circle." (LM9: Transcript 9, P.7, 8)

Thus, it is very difficult for LMs to do their jobs in state-owned banks since social *guanxi* in a Chinese bank is very complex. They need to balance many factors, they have to maintain a very complex *guanxi* system. Firstly, they have to think about the lending from their leader's standpoint and perspective, then their own standpoint (i.e. reducing their risks by shirking their responsibilities and gaining maximum interest), and finally caring about the borrower's feelings, which is called saving face for the borrower. They should consider the feelings of bank leader the borrower, moreover, they have to have the lending business done nicely.

From the above example, we can see that, although there are formal rules and

regulations in banks which restrict bank leaders' powder and monitor the final lending decision, these rules and regulations may still be infringed. As LM7 said,

> **"**We banks are also preventing this situation from happening nowadays; the so-called credit review meeting system, and the so-called veto power of president system all prevent it. What is the veto power of the president system? It means that our president has only veto power, but no decision-making power; he cannot decide on the loan. If the president wants to lend the loan, but the credit review department says no, then the loan still cannot be made. At the same time, if a loan is approved by the credit review department, the president can also veto it if he considers that there is problem with it. There is a mutual constraint and balance relationship between them. But *renqing shigu* is still inevitable; some [presidents] will do some work to persuade credit review approvers [to approve the loan]; this situation also occurs." (LM7: Transcript 7, P.8, 9)

Although the bank uses many formal institutions to avoid this kind of activity, from LM7's words and the example here, we can see that there are still ways to bypass the regulations, and that *guanxi* can affect even the CRD. The bank leaders can still communicate with the credit review meeting members and ask them to agree to the loan, so they still have the power to decide the loan. This situation probably did not arise in LM9's bank, but if it did, it could be a positive thing from his point of view since he would not have needed to be entangled with the lending. Thus, it can be seen here that *guanxi* can affect bank leaders, and ultimately affect the lending, so *guanxi* still affect the lending decision. EM4 takes a very interesting viewpoint that explains this situation:

> "The Chinese society is called a "rule of man" society, and not a "rule of law" one, which causes risks. But eventually, [we all need to] depend on a legal system; banks need regulations, enterprise need regulations, and management also need regulations, as it is hard to run the country well only depending on "rule of individuals". […] If it is ruled by people, it happens that when [decision makers] make mistakes, no one can supervise them that is why we need to depend on laws. What makes America so developed? It has a good legal system. (EM4: Transcript 12, P.12)

EM4's viewpoint also pointed out the difference between society in China and Western countries. In China, although there might be rules, people always to act according to *guanxi* or *renqing* rather than the rules. The "rule of man" society is also a reason why *guanxi* can affect lending regardless of the bank regulations. In the above example, the supervision problem also occurred since no-one could oversee the bank leader's fault of giving the loan to the bad borrower, because he was the top leader in that bank and ruled it. This is why EM4 considers that the operations of banks and enterprises all need to depend on regulations and laws. EM4's opinion is quite similar to that of Jacobs *et al.* (1995), and will be discussed later in Chapter 8.

7.6 Summary

Starting from the statement of the fact that it is easier to obtain loans from banks where they are acquainted with someone, this chapter first explains three very important dimensions of *guanxi* in practice: *xinren*, *renqing* and *ganqing*. These three elements are also three manifestations of *guanxi* in the real world. The research findings in this chapter show that *guanxi* can be improved through long-term interactions between the participants. This is because the trustworthiness level or *xinren* level increases after these interactions and hence, LMs would trust acquaintances more and would be more willing to give them loans. In addition, through long-term interaction *guanxi*, LMs can also obtain more internal information about the acquainted borrower and thus reduce the asymmetric information risk. While this is also an advantage over other banks in terms of maintaining the customer, it could also lead to the information rent-seeking and the lock-in problem, which will be discussed in the discussion chapter. Furthermore, from the standpoint of SMEs, *guanxi* could also help to obtain the loan easily, since banks may reduce some requirement of them, which makes *guanxi* popular and accepted by both sides on the Chinese SME-bank lending area. Therefore, *guanxi* is helpful in solving the information asymmetry problem and reducing the crisis of confidence between banks and SMEs in China. It is also presented in this chapter that *renqing* and *ganqing* also play important role on the lending process. *Renqing* as a tradition is embedded in Chinese society, and the findings show that it is also significant in the

lending process, particularly in decision-making.

Secondly, this chapter discussed another Chinese tradition, gift-giving, which has roots in *renqing* since *renqing* could be transferred through the exchange of gifts. Normal *renqing* exchange is a social norm and custom in China, reciprocal courtesy through the exchange of *renqing* is a cultural tradition. While the research findings show that gift-giving as part of *renqing* is abused in the SME-banking lending area, this was the case particularly in 2008 and 2009; people in the industry use it as an instrumental tool to pursue their own interests and lending decision-making is affected by this behaviour. Bank officials accept 'gifts' from SME borrowers and help them to obtain loans which they would probably not have been able to obtain otherwise. The findings show that many interviewees consider 'gift-giving' under *renqing* to be a determinant factor in lending decision, which is the dark side of *guanxi*.

The last section, Section 7.5 shows precisely how *guanxi* affects the lending decision-making, with one specific example presented in the section. The example shows that *guanxi* with bank officers and particularly local government officers, has significant impact on the lending decision, supporting the findings from Chen *et al.,* (2011b) exactly. Both Wu (2008) and Selmier (2013) mentioned that China's banking sector (i.e. legal environment, bank regulations) had improved considerably, and that it had become more difficult to obtain loans using the *guanxi* network. This can probably be attributed to the development in information disclosure in China, the rapid spread of information online and greater transparency on the Internet making it more difficult to hide *guanxi* corruption (Selmier, 2013). Some of my interviewees, such as like EM2, EM3, EM7 and LM6 agree with this. EM3 considered it to be more difficult to obtain loans from banks nowadays only by maintaining good *guanxi* with them. In this chapter, EM7 also revealed that *guanxi* with bank lenders might be useless when the loan amount is very large, since the bank lenders have to assume great responsibilities. Although EM7 considered that *guanxi* had less effect on lending large amounts with large enterprises, he did not deny its effects on SMEs, and he also mentioned in the interview that it was best to apply *guanxi* with the condition that the enterprise was performing well. I agree with these arguments; the situation is indeed improving in China, particularly in large

cities and large enterprises. However, most of the other interviewees' statements also show that it still happens in the present research areas or places as Chen *et al.* said, "in regions in which the local economy is less market-oriented or in which the [local] government has more discretion in allocating economic resources" (Chen *et al.,* 2011b: 229), where *guanxi* can still affect lending. The example presented in sub-section 7.5.1 support this contention.

Chapter Eight: Discussion

8.1 Introduction

In previous empirical chapters (Chapters 4 and 5), the current accounting information environment, loan evaluation and approval practices in China were analysed critically and initially, forming the background and foundation of SME lending analysis. It was found in these chapters that non-financial information is probably more valid than financial information in lending decision making. In addition to other non-financial factors, it was analysed in Chapters 6 and 7 that *guanxi* is considered as a traditional culture, an informal rule and a social capital that plays an important role in this process. Various authors have different opinions about the impact of *guanxi* as an informal rule in business operation. Some researchers argue that since China is transforming itself from a relation-based society to a rule-based society (Li, 2004), and due to the development of the market economy and rational law in China (Guthrie, 1998), *guanxi* is less important than it used to be in China (Selmier, 2013; Wu, 2008; Landa, 1981). However, others believe it is still important (Yen *et al.,* 2011; Dunfee and Warren, 2001; Huang, 2008), and is evolving, particularly among ordinary people and in interpersonal relations (Hsiung, 2013). Nolan (2010) conducted 26 in-depth interviews with managers of Western banks, who had experience of banking in China. From the interviews, he concluded that *guanxi* was still an important element in Chinese banking industry, despite the influence of Western corporate governance mechanisms. One purpose of this thesis is to find out exactly what role *guanxi* plays in SME lending and lending decision making through empirical research findings. Moreover, this chapter seeks to reinforce knowledge about this area by linking findings from this research to previous literatures and theories. As discussed in this chapter, some of the research findings support previous literature while others do not. Some new ideas are also presented and discussed in this chapter, which consists of two main sections. The first section seeks to examine in depth where latent rules such as *guanxi* come from, and how *guanxi* works in SME lending from a cultural and instrumental perspective. The second section seeks to discuss how *guanxi* substitutes for formal institutions, and the 'mutual effect' between them through the discussion of defects in formal institutions, insufficient enforcement

and unsound institution supervision, and explains how this phenomenon could affect lending. In addition, the *guanxi* structure, embeddedness theory, institution and institution change theory are applied here to discuss these topics.

8.2 Culture embeddedness of *guanxi* as an instrumental social capital tie

Since the publication of Wu's (2001) book, the word *"qian guize"* (*潜规则*, latent rule) has been widely used in China. According to the literature, the formation of a latent rule or informal rule stems from China's traditional political and economic systems (Wu, 2001; Feuerwerker, 1984; Fei, 1992; Tsang, 1998; Hsiung, 2013; also see Chapter 3). Determined by the small-scale peasant economy system and feudal autocracy political system, *guanxi* as a type of informal rule has a long history in China and has had a widespread effect on Chinese society (Wu, 2001; Park and Luo, 2001; Yen *et al*., 2011; Lovett *et al.,* 1999; Huang *et al.,* 2013). *Guanxi* is an integral part of Chinese culture, and China is a country which attaches great importance to its traditions; therefore, the concept of latent rules and *guanxi* has infiltrated into every Chinese person's mind (Park and Luo, 2001; Yen *et al*., 2011; Luo *et al.,* 2012). Wu (2001) mainly talks about how latent rules worked in the period of Imperial China and particularly under the feudal autocratic political system in an agricultural country. In Wu's work, *guanxi* is the most important latent rule in China and is embedded in Chinese culture (Wu, 2001). According to the embeddedness theory, economic behaviours are embedded in social relations (Granovetter, 1973, 1985; Landa, 1981; Chan, 2009; Hisung, 2013); *guanxi* as the manifestation of social relations in China derives from the traditional Chinese culture and is also affected by institutional (particularly policy) change. Specifically, China has been undergoing a process of transformation from an agricultural country to industrial country in the last few decades, and during this process, it was found in this thesis that *guanxi* has started to be used as a social capital alongside commercial logic, rules and systems in the SME lending area, rather than just a cultural tradition or a way of life as in the past. As a social capital, people can use it to achieve certain purposes, and in the SME lending area, *guanxi* is also used by both LMs and SME managers to proceed through the lending instrumentally. The research findings reveal that *guanxi* is

sometimes used as "lubricant" during this process, while it could also probably be a factor that ultimately determines the lending decision. As a social capital and which could be used instrumentally, *guanxi* has many dimensions, features and functions reflected in previous literatures and also from the research findings. For example, *guanxi* has three dimensions: *renqing* (favour), *ganqing* (feelings) and *xinren* (trustworthiness). Moreover, some researchers (Hwang, 1987; Yum, 1988; Luo, 1997, 2007a; Wang, 2007; Huang *et al.*, 2013; Su and Littlefield, 2001; Yau *et al.*, 2000) conclude that *guanxi* is transferable, reciprocal, empathetic and utilitarian, and it was found in this present research that, as well as these four features, *guanxi* is also exclusive and 'indirect'. In addition, it is indicated in previous chapters that these different *guanxi* features, which derive from traditional Chinese culture, have different impacts on lending. Hence, the following sub-sections will discuss the cultural embeddedness of *guanxi* based on the structure of the aforementioned three dimensions and six features, namely, *guanxi* structure.

8.2.1 The 'indirectness' and empathy features

In Chinese culture, people usually do not like to refuse or reject others; this is known as "saving face" of these others. Even when they want to refuse someone, they do not like to do so directly. Because it is culturally treated as negative if you say 'no' directly to someone and make him or her "lose face". If you do this, you will be considered as unkind and which also means you do not care about your *guanxi* (Kriz and Keating 2009; Kriz *et al.*, 2014). In this respect, based on his own experience in China, Luong (2015) discussed ways in which Chinese businessmen refuse others indirectly, one of which is that they just ignore the topic and start talking about something else that is irrelevant. Although the image is different, the logic behind it is the same. In the SME lending area, they will also go around the subject and do it 'indirectly'. For example, when LMs are interacting with new borrowers, they will not move to the lending business topic directly at the beginning, but talk about other irrelevant matters first. Or, when the LMs are investigating SME managers, they will not ask directly about their circumstances, but enquire indirectly through common friends. These behaviours all have common points; they are all informal and conducted with 'indirectness'. Several

other researchers have similar explanations about this phenomenon or behaviour, relating it to the empathy feature of *guanxi* (Wang, 2007; Yau *et al.,* 2000; Hwang, 1987). According to the literature presented in Chapters 2 and 3, this behaviour derives from the traditional empathetic thinking mode of Chinese people, which is guided by the Confucianism. A further review of the literature reveals findings indicating that 'indirectness' is also embedded in Chinese culture, deriving from the "*Wulun*" (five cardinal relations, see Chapter 3) concept of Confucianism. *Wulun* concerns the five basic relations among people in China, but, more importantly, it teaches people to behave well in these relations and to be in harmony with others. The 'indirectness' phenomenon is the result of following these guidelines. According to Wang (2007), people who follow this rule of empathy possess and know *renqing*, which means they can understand others' feelings and emotions, and are always ready to fulfil others' needs. The research findings also show that *guanxi* is used to build a well-connected relation and network through etiquette as a means of social contacts, thus allowing people to further their own interests, and that this process is also a game between the participants. The premise of the game is that they should not make each other uncomfortable and maintain their *guanxi* well.

During the data analysis, many examples of the 'indirectness' feature were found throughout the whole lending process. For example, at the stage of developing new customers, it makes sense that LMs would not introduce the business directly, since it might make the new customers uncomfortable. In Chapter 6, it was found that LM5 used an "indirect" strategy to develop new customers successfully, which involves talking about something else irrelevant, establishing the *guanxi* with customers first and then moving "indirectly" to the business later. Normally, tenants in the market would become annoyed with people from banks who introduce bank products, but in this indirect strategic way, LM5 makes his customers feel relaxed and at ease since he establishes *guanxi* with them first rather than introducing the products first. At the same time, a counter-example was also provided by LM5, showing how bad the result could be if this social norm and informal rule was not followed during the lending process. In addition, when LMs are investigating SME managers or enterprises, one reason why they investigate through other tenants in the same market (shown in Chapter 6, section

6.4) or through other things such as the condition of cars parking outside the enterprise (Chapter 5, section 5.2) "indirectly", is because they cannot distinguish whether the financial data or what the SME manager tells them is true or not, but more importantly, they do not want to embarrass the SME manager by investigating and asking him directly, as this would make the SME manager think they do not trust him. Even when asking other tenants about the borrower's circumstances and reputation in the market, LMs do not move to the topic directly but start with small talk, since they do not want to make their intention obvious. It is also shown at the end of Chapter 5 that even when LM9 does not want a loan to be approved, uses the credit review department (CRD) as an excuse to reject it, since he can thus transfer the responsibility to the CRD in this indirect way, so that the borrower cannot blame him and their *guanxi* will not be broken. This is the logic of doing business in China, and the nature and purpose of this 'indirectness' is to preserve the *guanxi* between LMs and SME managers. Hence as can be seen here, the use of *guanxi* in the SME lending area derives in fact from the empathy feature which is guided by traditional Confucius social norms. Furthermore, the "indirect" phenomena found in this research are the manifestation of the empathetic thinking mode of Chinese people, with the empathy feature as the underlying cause. Previous literatures mainly explained this empathy feature theoretically, but few studies have used empirical examples to show the manifestation of the empathy feature. This present research has extended this area by offering empirical explanations concerning the empathy feature of *guanxi*. In addition, it defines the concept of 'indirectness', which explains the behaviours of Chinese people in terms of the empathetic thinking mode. In this way offers a deeper understanding the root of *guanxi* and the use of *guanxi* in SME lending area. Thus, the study makes a contribution to the body of knowledge and to theory.

8.2.2 The transferable feature and the reciprocal feature

Many researchers (Dunning and Kim, 2007; Park and Luo, 2001; Luo, 2007a) gave theoretical definitions of the transferable feature of *guanxi*. However, there is little literature explaining the application of this feature in practice, or exploring in depth what is transferred during this process. In addition, this research also enhances the basic

hypothesis of embeddedness theory: when A has strong ties with both B and C, then the possibility of B and C knowing each other is also higher (Granovetter, 1973: 1362). Although Granovetter (1973) gives some explanations and refers to some empirical evidence as why this happens, he still considers this evidence as insufficient. This research not only provides empirical examples to show this hypothesis is applicable but also explores the reason why it happens in the Chinese context. So this research could fill these gaps empirically. For example, findings in Chapter 6 show that LMs would use old customers' *guanxi* to develop new customers, by asking old customers to introduce their friends to the bank, namely, 'customers introduce customers'. This case corresponds exactly to the hypothesis explained previously, and is similar to the concept of the '*guanxi* Bridge' proposed by Kriz *et al.* (2014: 34). According to Granovetter's (1973) classification of given ties and the strength of *guanxi* presented in Table 2.1 (Chapter 2), a high level of *guanxi* could be considered as a strong tie, medium and low level *guanxi* could be considered as weak ties. Therefore, the old customer (A) here has strong ties with both the LM and his friends, and the LM (B) and friends (C) are going to get to know each other. Furthermore, many LMs mentioned in their interviews that 'customers introducing customers' is a very common way to develop new customers in China. But why does this happen? In fact, this process transfers *guanxi* and *xinren* (trust); indeed, new customers are introduced to the LM through their *guanxi* with the old customer. Because new customers trust the old customer (since they are usually close friends and have strong ties), they will trust the LM (who has been suggested by the old customer) as well. Hence, new customers' *xinren* as one element of *guanxi* is also transferred from the old customer to the LM in this process. Granovetter (1985) considers trust to be the understanding of someone from other people; it is a person's reputation in society that makes him or her trustworthy. In this case, trust in the form of *xinren* is transferable. The essence of this transfer is also the exchange of *renqing,* and in this case, the LM would owe *renqing* to the old customer for helping introduce new customers. More details about *renqing* transfer and exchange will be given later in this sub-section. In conclusion, *guanxi* is used as a social capital here; the loan mangers use old customer's *guanxi* (or more specifically, the new customers' *xinren* towards the old customer) to obtain new customers.

Additionally, LMs could also use this feature to investigate SME managers before the lending; the investigation through 'common friends' (CF) *guanxi* presented in Ch.6 is a good example of this. Two types of CF *guanxi* were found from the empirical data; one is named direct CF *guanxi*, which means the investigator (LM) knows the common friend directly and well, and these CFs also normally have close relationship with the borrower SME manager since they are usually friends or people in the same industry. The other type is called indirect CF *guanxi*, which means the investigator (LM) knows the common friend from a *guanxi* circle through an intermediary. Indirect CF *guanxi* is more complex than the direct one, so it will be analysed first. It was revealed in Chapter 6 that LMs such as LM9 seek the information they want from other people such as their colleagues' customers, namely, 'common friends'. In this indirect CF *guanxi*, the LM (let us say A) wants to investigate the SME borrower (B) through his colleague's (C's) customer (D). It is therefore obvious that C has strong ties with A and D, and B also has a strong tie with D, while the relationship between A and D is weak tie, since A only knows D through C. Thus, according to the embeddedness theory, the weak tie has more advantages in terms of obtaining and spreading information (Granovetter, 1973 and 1983). In this case, the theory is supported, as the reason why LM wants to investigate the borrower (SME manager B) through the common friend (D) is that he could obtain more information from D which might not be able to obtain from the borrower (B). In this case, information about B is obtained by D from B or their *guanxi* circle, and then transferred from D to A through the weak tie between them, so the weak tie between A and D could provide valid information about B. In addition, it should be noted that A is not only connecting D with but also the *guanxi* circle (or network) which includes D, if the information is obtained from this circle. Hence, this weak tie plays the role of 'bridge' here, but more importantly and as a supplement to the embeddedness theory, this 'bridge' is established with the help of C as an intermediary; without C, this process could not occur. Because C has strong ties with both A and D, in order to establish the 'bridge' between A and D, strong ties are still needed to be the 'bridge pier' here; although they do not perform the function of transferring information, they are the foundations of the 'bridge'. Therefore, the essence of indirect CF *guanxi* in this case is the use of a weak tie as a 'bridge' to obtain information and of strong ties as 'bridge piers' to support the

bridge. Indeed, during this process, not only information but also *xinren* (trust) are transferred. Since A believes he can trust C, and C also trusts D, they all believe that D will provide true information, and because D has a strong tie with B, B would not or not able to give false information to him either (since D knows B well). Hence, information obtained in this way is comparatively more objective and accurate than information obtained by the LM (A) directly from the borrower (B). In this way, A's *xinren* is transferred from C to D through their strong ties (A-C, C-D), which makes A could trust D as well, but information is transferred through the weak tie from D to A in this indirect CF *guanxi* investigation.

However, direct CF *guanxi* is much simpler. In direct CF *guanxi*, the LM (A) investigates the borrower (the SME manager) (B) directly through a common friend (C), they are all in the same group or *guanxi* circle, C is a good friend who knows B well and have connection with A, which means A-C, B-C ties are normally strong ties. However, A has a weak tie with B since B is new to A, so A does not know B well and has to investigate him through C. In this case, the *xinren* (trust) is transferred directly from A to C and information is obtained by C from B and given to A. Nonetheless, it should also be noted that this model is a very basic one, as there could be more common friends (CFs) involved to form a more complex model. However, the more complex model falls outside the scope of this research, and it is therefore unnecessary to discuss it. In addition, it has also been shown here that the "forbidden triad" situation mentioned by Granovetter (1973: 1363) would not happen in this case, since, the findings show when C has strong ties with A and B, A and B already have a weak tie, contrary to the premise of the "forbidden triad", which is that between A and B there should be an absent tie. Furthermore, it is also shown in the empirical data that after the lending and many interactions, this weak tie could turn into strong tie and create trust between A and B, since it will good for the future cooperation. This finding corresponds exactly to Newcomb's argument about mutual 'high attraction' cited by Granovetter (1973: 1364). In conclusion, the discussion here corresponds to the embeddedness theory but also supplements it, as it explains the essences of strong ties and weak ties in the Chinese context (*guanxi*) in the SME lending area, which Granovetter may not be able to explain fully. Hence, the discussions above make a theoretical contribution by extending

Granovetter's (1973; 1985) theory about weak ties and strong ties, supported by empirical findings.

It is indicated from the research findings that the transferable feature is always accompanied by the reciprocal feature. According to a number of studies (Huang *et al.,* 2013; Park and Luo, 2001; Luo, 1997 and 2007a), reciprocity is one important feature of *guanxi*. In China, where great importance is attached to traditional culture, Chinese people pay great attention to this traditional social norm of reciprocity. Hwang (1987) defines it as a social obligation and a common perspective that people in China will obey, and it means if someone receives a favour from others, then he owes *renqing* to them and should be ready to pay it back. Wang (2007) considers that maintaining a healthy *guanxi* is a key element of Chines society, since "Chinese people place a high value on the obligation of reciprocation" (Wang, 2007: 84). Therefore, it can be seen from previous literature that reciprocity is a social norm and obligation in China, and that those who do not follow it would be considered unkind and might not fit well in Chinese society, nor as in the SME lending area. It has also been proven in this thesis that *guanxi* between acquaintances is often built on the basis of reciprocal courtesy, into which the parties bring their respective appeals for their interests and develop cooperation with those who may assist them. It has been shown in the empirical chapters of this thesis that interpersonal *guanxi*, i.e. *renqing*[14] as part of *guanxi,* is very important, since it is the form of this reciprocal exchange of favours; people exchange *renqing* to enhance their *guanxi* and then achieve their purpose. SME managers give 'gifts' to bank officials, and in return, bank officials help them to obtain a loan as an exchange of this *renqing* (favour), this process is defined as *renqing shigu (人情世故).* It is also discussed in the empirical chapter (Chapter 7) that, I translate *renqing shigu (人情世故)* as the operation of *renqing*, which differs from other researchers (Guo and Miller, 2010; Ruan, 2017). It is because bank officials need to repay this *renqing* due to the reciprocal norm, which makes them agree to the lending, and ultimately affects the lending decision. Therefore, this also explains why *guanxi* as a non-financial factor and latent rule could play such a significant role on the SME lending decision-making, since

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[14] The definition of *renqing* is presented in the literature review chapter (Chapter 2)

it is a social capital and has, in recent years, gradually becomes a tool instrumental in the pursuit of interests, which could help those who use it further their interests. Thus, *guanxi* based on the reciprocal feature could ultimately affect lending.

The real-life example given in Chapter 7 also shows that *renqing* does not need to be manifested in the form of a real gift, but also could be an intangible favour. When a bank leader lends to an unqualified borrower, it means the government official owes *renqing* to the bank leader at the same time, and so the government official will not make difficulties for him afterwards. The government official might even give him a promotion in his career or special business attention as a return of this *renqing*. After all, the bank is state-owned under the jurisdiction of the government, and the government also has considerable deposits in the bank; hence the government official could affect the lending by putting pressure on or offering benefits to the bank leader officially and unofficially. This finding corresponds to the findings of Chen *et al.* (2011b). However, generally speaking, it is still because the borrower has a good *guanxi* with the government official and he uses this *guanxi* to affect the bank leader that the lending is decision made. Or, more specifically, the borrower uses his *guanxi* with the government official to affect the bank leader's *guanxi* with the government official, which ultimately affects the lending. The reason why the government official wishes to help the borrower might either be because their *guanxi* is like that of true brothers (or so it appears from LM9's words), or because the government official could obtain some favours from the borrower (but we cannot know this), while it is seen clearly from the discussion above that the LM could definitely receive some favour or benefits from making the loan. Let us suppose the government official could obtain some favour from the borrower, the favour does not need to be in the form of money or luxury gifts, as EM10 mentioned in Chapter 7; some people just want *ganqing* and the feeling of being greatly admired, which could also be favour here. According to the embeddedness theory, Granovetter (1985) defines this kind of favour as the 'pleasure' that could be obtained from social interactions in daily work, which is a personal desire and part of human nature (Granovetter, 1985: 498). Thus, long-term *guanxi* could bring social identity and social satisfaction for the participants and generate *ganqing* among them. In this case, it can be seen that the favour is transferred firstly from the borrower to the

government official, and from the government official to the bank leader secondly (in the form of benefits from the government official), and finally, from the LM back to the borrower (in the form of obtaining the loan). So favour transfer is cyclical here, and if it goes clockwise, then the transfer of *renqing* behind it goes anti-clockwise. For example, when the bank leader makes the loan to the unqualified borrower, which is a favour, this means borrower owes *renqing* to the bank leader, and this *renqing* is compensated by the favour from the government official. Hence, in this case, the bank leader owes *renqing* to the government official, and this *renqing* is compensated by the favour from the borrower to the government official. Again, in this case, the government official owes *renqing* to the borrower, and this *renqing* is compensated by the favour from the bank leader to the borrower, since the bank leader makes the loan to the borrower, which is a great favour. Thus, it is like a bilateral circulation; favours and *renqing* are transferred in this cycle and all the participants receive what they want from this cycle. This is therefore a good example of how Chinese *guanxi* works among three participants in the SME lending area; *renqing* as part of *guanxi* is transferred and exchanged as a social capital and it is reciprocal among all the participants. It is also revealed from the above discussion that *guanxi* includes elements of human needs, which is respect for other people and reciprocal courtesy. *Guanxi* is to some extent the fulfilment of human desires and needs, and it also contains the concept of values, ethics, traditions and cultures.

Huang *et al.* (2013) consider that the concept of reciprocal favour exchange is practiced in the short term in Western society, while *renqing* exchange in the Chinese content is a long-term process. Other researchers believe that *renqing* as part of *guanxi* could be stored and paid back whenever the bestower needs it, so the return of *renqing* as part of *renqing* exchange does not need to be immediate but could take place in the long term (Wang, 2007; Yum, 1988). It is also identified from the research data that *guanxi* and trust are built through long-term interactions of the participants; furthermore, this research finds that this connection will not end with the conclusion of the lending transaction. This means that once *guanxi* is built, the participant can use it later and it will probably last a lifetime, provided they maintain it well. As EM5 indicated in Chapter 6, as long as the *guanxi* is there, he might still use it to cooperate with the bank

next time even if he was not able to obtain the loan this time. This finding corresponds to previous literatures and also explains why *guanxi* could last for a long time and could be used as a long-term social capital, not only for a single use. LM9 also had a similar opinion, which is exactly the same as that of Wang (2007) and Yum (1988), who consider that the long-term maintenance of *guanxi* is very important since it could turn *guanxi* into a valuable and rewarding social capital. LM9 also considered that this *guanxi* resource and capital might not be used immediately but probably could be in the future, which means if he left the bank and went to work for a new bank, then he could take *guanxi* with him and exploit it when needed (i.e. use it to develop customers for the new bank). Therefore, *guanxi* is not only an informal rule in China, but could also be used instrumentally as a long-term social capital and resource.

8.2.3 The utilitarian feature, the exclusiveness feature and the *guanxi* circle

Luo (2007a) defines *guanxi* as utilitarian rather than emotional and considers that while it is preferable for friendship to be involved in *guanxi,* it is not a necessity. However, there is a saying in China that before doing business or being business partners, you should become friends first. If you are friends, this means you have good *guanxi* with each other. Luong's (2015) business experience in China support this saying, as do other findings in this research. Nevertheless, the research findings in this thesis also imply a different explanation for this 'friendship'. Some interviewees (i.e. LM2, LM3, EM4 and LM9) said (see Chapter 6) that they would make friends with their counterpart during the lending process, while others would not (i.e. LM4, LM6). Therefore, *guanxi* could be either utilitarian or emotional. After the analysis of all these data, it is found that probably not all of them are truly making friends with each other, although some might be. The 'friendship' here is sometimes used as a social capital by LMs for the purpose of risk control, and SME managers could also use it to ensure the granting of loans as well as to reduce policy uncertainties, since they could also obtain some information about policy changes from LMs through this 'friendship'. In general, the establishment of *guanxi* is the first step of 'making friends'. After establishing *guanxi* and friendship, the participants could obtain what they want from it, which means LMs would try their best to obtain internal information about the borrower, while SME managers would use it to obtain loans.

Like close friends, acquaintances can help each other for the purpose of obtaining profits or supports in the future. Therefore, latent rules such as *guanxi* seem to work usually among acquaintances, and it is indicated from literature that relying on acquaintance *guanxi* is a social phenomenon deriving from the fear of the unknown and has existed since ancient times; people depend on others to survive (Rawski, 1972). In fact, it is in the oldest principle of interest-driven utilitarianism. *Guanxi* gradually evolved into an instrumental tie as well as an important factor in the evolution of current latent rules, because it allows internal members to make exchanges with each other in their own interests when social resources were limited (Zhang and Zhang, 2006; Landa, 1981). Since the existence of various formal rules resulted in differences between the resources obtained by people in different circumstances (He, 1998), individuals had to obtain resources which could be obtained according to formal rules by resorting to informal rules, such as through the application of *shuren* (acquaintance) *guanxi*. Because acquaintance *guanxi* is a strong and high level *guanxi,* this means acquaintances are people you know well and who would generally like to assist you. This is the origin of the importance of acquaintance *guanxi* in lending decision-making in China; as shown in Chapter 7, acquaintances have advantages over strangers in obtaining loans for SMEs. It should be noted that that Granovetter (1973) defines the relationship between friends as the strong tie, and that between acquaintances as the weak tie (Granovetter, 1973: 1368). However, the definition of acquaintance *guanxi* in this thesis is different. In this thesis, the relationship or *guanxi* between acquaintances is actually stronger than that between friends, since acquaintances also include relatives or close friends in this research, so acquaintance *guanxi* is considered as a very strong tie here, even stronger than the friendship tie.

With respect to acquaintance *guanxi*, LM9 stated (see Chapter 6) that people who know each other well (e.g. people in the same industry) gather together and form social circles. The Chinese scholar He (1998) calls this kind of circle *guanxi quan* (*关系圈*) and which is translated here as '*guanxi* circle'. A *guanxi* circle could also be defined as personal "groups in confined institutional or organizational settings" (Granovetter, 1973: 1376). As He (1998) states, as a combination of the owners of various resources and powers

unite based on relationships of complementary interests, this informal social network becomes a resource that supports resource allocation inside the circle, due to its ability to influence the flow of many resources and their directions. Power sharing and exchange formed with latent rules and an informal social network (the *guanxi* circle) can greatly reduce the cost of transactions between insiders while increasing the costs for the "outsiders" (Landa, 1981; He, 1998). Thus, according to He's (2008) definition, the formation of this *guanxi* circle concerns interest exchange, power sharing and resource allocation. Moreover, Wang (2007) considers that in a low-trust country, Chinese people prefer to trust and conduct business with people who are in the same exclusive *guanxi* network and circle, rather than outsiders. Hence, the nature of a *guanxi* circle is to set up barriers to those who want to enter the circle (Wang, 2007). A *guanxi* circle as another instrumental tool based on *guanxi* therefore has the feature of exclusiveness. After the formation of *guanxi* circle, the participants in the network and who could profit from it are called "insiders". The research findings in Chapter 6 show that information also spreads fast inside *guanxi* circles and people in the same circle could obtain it easily; as LM9 asserted (in section 6.4), outsiders probably do not have the chance to obtain internal information instantly. This means that the cost for "outsiders" to obtain information from inside the circle would be higher than that for "insiders". For banks and LMs, more internal information means they can be more confidence in making the lending decision, since the information asymmetry problem could be reduced and so the risk will be lower. It is therefore very important to be "insiders", and the method of using "common friends" *guanxi* to investigate SME managers also involves use of the *guanxi* circle here, as these people are all normally in the same circle. In general, *guanxi* is used as a method to obtain sensitive and non-public information about SME managers, information which would be difficult to obtain outside the *guanxi* circle. As can be seen from the empirical data in this thesis, this a very common use of *guanxi* during the lending process, and it is exclusive. This finding extends the perception of *guanxi* particularly in the SME lending area. It also enhances the importance of the indirectness feature of *guanxi* as discussed previously, as the reason LMs do it "indirectly" is not just to "save face" but has another practical implication: it could obtain some valid and meaningful information from *guanxi* and the *guanxi* circle.

Once participants are involved in a *guanxi* circle, provided that the cooperation has developed over a long period, the longer the period of cooperation, the more difficult it is for them to quit. Even if there is a dispute or conflict between the participants subject to latent rules, the disadvantaged participant would prefer to regain stable returns through further cost inputs (North, 1984, 1990, 2005). According to North's institutional change theory, this phenomenon results in a 'lock-in' situation, which, in turn, results in 'path dependence'[15] (North, 1990: 94; North, 2005: 52). The empirical data in this thesis show that this situation also arises in the SME lending area. LM5's words in section 7.2 of Chapter 7 demonstrated this lock-in situation; he explained the advantages of this lock-in *guanxi* with SME managers in terms of three aspects: efficiency, revenue, and further cooperation in lending transactions. Revenue refers to LMs being able to gain more profit from acquainted borrowers. Conversely, SME managers have to pay more. This is because the borrowers trust this LM, but not others, so they do not care even if they have to pay more interest; thus, they are locked into this *guanxi* and it is difficult for them to quit. The SME managers are disadvantaged participants in this case, but they would rather to pay more interest to acquainted LMs in order to maintain this cooperation, since they consider that it is more stable to cooperate with acquainted banks and the possibility of obtaining loans from them is higher than it would be from non-acquainted banks, corresponding to North's theory. In addition, although SME managers will probably need to pay more interest, they could also save some search or negotiating costs dealing with these acquainted LMs rather than new ones, since they know each other well and do not need to negotiate a great deal. They are more afraid of spending more time, energy and even money to negotiate with new banks but with the potential of failure. Furthermore, as another loan manager LM2 explained in Chapter 7, the reason why a longer period of cooperation would lock the borrowers deeper into this *guanxi* is that, from this long-term cooperation *guanxi*, the bank could obtain more internal information such as accumulated credit records about the enterprise and the SME manager, while other banks would not have this opportunity. And the enterprise or the SME manager would also rely more on the bank

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[15] North (2005: 52) defines the path dependence as "the constraints on the choice set in the present that are derived from historical experience of the past".

in turn, which is in fact a type of information rent-seeking (Su and Littlefield, 2001). Under this condition, long-term *guanxi* is also used by banks as an instrumental tool to "lock in" SMEs; the longer their cooperation lasts, the more difficult it is for the SMEs to quit and turn to another bank. This is the disadvantage for SMEs; however, the advantage is that they do not need to worry about loans if they have this *guanxi* with the bank, although the costs might be higher. In conclusion, based on the discussion of *guanxi* dimensions and features, this section shows the importance of *guanxi* in the SME lending process and in its decision-making. SME lending is embedded in *guanxi* in China, and *guanxi* is affected by the traditional Chinese culture and historical institution changes; hence, this section argues that *guanxi* affects lending instrumentally based on its cultural roots, that is, the cultural embeddedness of *guanxi*.

8.3 *Guanxi* as a supplement to or substitute for formal institutions

It was discussed in the theoretical framework that informal rules could substitute formal institutions and assume the functions of facilitating economic activities, stabilising social and economic order when the formal system is weak (Hsiung, 2013; Luo *et al.*, 2012; Dunning and Kim, 2007; Zhang and Zhang, 2006). It was found in the analytical chapters that there exist both formal and informal management systems and institutions in Chinese financial organisations. All banks practice formal systems in their normal operations. At the same time, there are also some informal procedures and rules practiced by LMs. North (1990) considers that formal institutions only account for a small part of the constraints and informal rules are more universal than formal ones in social life. If bank management is compared to an iceberg in the ocean, the formal rules such as formal regulations and loan requirements in the bank are merely its tip above the sea level, while the informal rules such as culture, and interpersonal *guanxi* inside or outside the bank constitute the larger part of the bank management. In this light this section will discuss the role that informal rules such as *guanxi* play in bank management specifically during the transition period, during which formal institutions appear to be weakened and lose their intended functions.

8.3.1 Unsound formal institution and institution deficiencies

According to institution theory, formal institutions play a guiding role in social development (North, 1990; Dunning and Kim, 2007). However, during the rapid development of China in the transition period, formal institutions which had previously been embodied in the planned economy system were weakened, but the formation and development of the new market-oriented formal institution system did not keep pace with Chinese economic development (Peng and Heath, 1996), so these formal institutions gradually fell behind the development of social practices such as those in the economy and market (Qian, 2000; Zhang and Zhang, 2006). This resulted in a situation where, unlike other domains (e.g. the economy and the banking industry) which developed rapidly, the legal system made only slight progress and became greatly disconnected from Chinese society (Liang, 2007). This implies a lack of new formal institutions designed to reduce uncertainties in social exchange and transactions, including those in the banking industry. As there was a lack of appropriate law to abide by, China adhered to the principle of "Nulla Poena Sine Lege" (Hall, 1937: 165; Potter, 2005), which made it impossible to convict those who commited any number of crimes and thus damaged the normal social order. Hence, in the face of many new unreasonable and unacceptable phenomena, nothing could be done. The "debt evasion or denial" (*taofeizhai, 逃废债*) problem discussed in Chapter 5 is a very good example of this. If SME manager who is still able to repay part or all of the company's debts has a dishonest personality, he could transfer the assets of the enterprise to other people or another place, declare bankruptcy, leave the asset-less enterprise to the debt holders and 'run away' from it, thus defaulting on the debts. He might even ask other people to register a new company and set up it just beside the old bankrupt one. In this case, neither the creditors nor could the government do anything to the defaulting SME manager, as there is no law to regulate or punish him. In the event that no provision was made under a legal system, the parties concerned would compete with each other for the purpose of maximising their own profits, or yielding a 'win-win' result, which provides an opportunity to implement informal rules. In this case, the defaulting SME manager simply maximised his own interests but ignored the creditors, such as banks.

Additionally, in any organisation, the formal rules and regulations on the table could not be completely correct and perfect, and when formal rules and regulations cannot promote the development of the organisation, informal rules will have a moderating effect (Luo, 2007b). Latent or informal rules fill the gaps left by unsound formal rules; with unwritten and highly flexible latent rules, problems can be solved in a time-saving, convenient and rapid manner (Zhang and Zhang, 2006; Wu, 2001). Hence, people prefer latent rules and formal rules exist in name only. This situation also arises in the banking industry in China. The development of banks has been rapid, while the development of bank institutions and rules has not kept pace with it. It is found from the empirical data that the formation of latent rules in bank management is mainly due to the imperfection of formal institutions and rules, leading to the existence of reasonable informal rules. These informal solutions are manifested in the application of *guanxi* as an informal rule in Chinese banking industry.

In the SME-bank lending area, one reason why many SMEs are not able to obtain loans from banks is because they cannot reach banks' requirements. They therefore have to take action such as providing false financial statements to pass the examination of formal rules in banks quickly and efficiently. At the same time, the LMs or bank leaders who are affected by *guanxi* would also cooperate with the SMEs not only in pursuit of their own interests but also to 'sell' loans for their bank by accepting these false statements. EM4 points out that banks use performance evaluations or incentive policies as incentives for LMs to 'sell' more loans, which is another factor leading to this situation. Many other LMs said (see Chapter 4) that they would not be able to make any loans if they did not break formal regulations, as otherwise, since most of the enterprises are not qualified according to the formal lending requirements, they could not make a profit and survive. From the SME managers' perspective, in order to obtain more loans than they could expect, SME managers such as EM10 would falsify and overstate the annual sales on his financial statement. So, on the one hand, in order to reduce risks, there are formal rules or official criteria (see Chapter 4, section 4.3) in the bank to impose requirements on their customers. On the other hand, although it may be against the rules, banks and LMs will loosen the requirements in practice; they will accept false financial statements in order to do more business. This supports Xiao *et al.* (2004), who

found that the effectiveness of Chinese accounting regulations has been undermined by a number of other factors such as weak corporate governance mechanisms.

This has several effects: firstly, since the bank is equally morally bankrupt and supports the company, this legitimises the actions of SMEs. Secondly, because of the perverse results it delivers, it also calls into question of other types of formal institution, such as the bank's lending criteria (i.e. the requirement of SMEs' accounting information), since they are no longer suitable for the bank's development. Hence, new formal institutions need to be designed. Generally speaking, the SME manager is cast as little more than beneficiary of the bank's inadequacy, but the bank can also benefit, so it results in a 'win-win' situation. The main reason for this situation is that various rules and regulations of the bank cannot keep the pace with its development; therefore, before new formal rules are established, informal rules will continue to play their parts in this stage. While SMEs are seeking loans, banks are seeking profits and LMs also try to 'sell' as many loans as they can, so many problems can arise including the emergence and acquiescence of fraudulent financial statements, or the negative implementation of *guanxi*. Therefore, in addition to formal institutions being ignored by bank officials, the formal rules themselves may also be part of the reason there is so much false accounting information in Chinese SMEs: since SMEs cannot reach banks' requirements, SME managers provide false statements in order to fulfil banks' requirements and obtain the loan (or more loans). To some extent, SMEs are forced to implement informal rules (such as providing false accounting information and using *guanxi*), since they would not be able to obtain adequate funding otherwise.

8.3.2 Insufficient enforcement and the choice between "rule of man" and "rule of law"

According to North's institution and institution change theory, formal rules can change rapidly since the government can announce a new law or change an old one immediately. In contrast, it takes time for the informal rules to evolve since they are normally embedded in culture, and it may take decades to form new cultural constraints (North, 1990). After the founding of the new P.R. China and particularly since 1978, starting

from constitution to department law and then moving to various regulations and judicial interpretations, legal systems were gradually established (Potter, 2005; Turner *et al.,* 2015). During this transition process, although China issued many laws and regulations to normalise and guide people's behaviour, these regulations were universalised, highly generalised and difficult to put into practice (Liang, 2007), making it difficult to obtain an ideal result in practical application. A formal institution is characterised by rigidity which requires the execution of formal systems according to legal procedures (Jacobs *et al.,* 1995), but its delayed response makes it impossible to make a timely adjustment should any change occur in practical situations. Moreover, a rapid change in formal institutions would be inconsistent with informal rules, as the culture may not respect the new formal rules (Li, 2004), thus producing institutional uncertainty (Park and Luo, 2001).

Affected by the feudal autocracy political system in ancient China, the concept of "rule of man" which had been entrenched for thousands of years was more flexible and efficient in evading formal rules than the 'rule of law'. According to Xunzi[16] cited by Turner *et al.* (2015), *"Law is essential for order, but the superior man is the source of law. So when there is a superior man, even incomplete laws can extend everywhere. But when there is no superior man, even comprehensive laws cannot apply to all situations or be flexible enough to respond to change"* (Turner *et al.*, 2015: 3). Unlike other Confucians who focused more on the establishment of personal morality, Xunzi emphasised the importance of legality to regulate people's behaviour. Although he was a consistent supporter of formal institutions such as law, he still pointed out the importance of man in conducting these laws. Specifically, due to people's instinct to avoid risks when seeking their own profit (Wu, 2001), those who maintained and executed the law would consider the ways to implement formal rules and make a choice between the 'rule of law' and the 'rule of man'. China is a relation-based country and the traditional ideology of 'rule by man' is deeply rooted in Chinese society (Li, 2004; Jacobs *et al.,* 1995), so the enforcement of formal institutions is a considerable problem in China. According to North (1990), informal rules are more universal than formal

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[16] Xunzi (d. ca. 210 B.C.). Xunzi was a great Confucian philosopher and thinker who was born in 313 B.C. and died in 238 B.C.

rules in social life, which means that the impacts of formal rules might not be as great as the informal constraints of the society (Dunning and Kim, 2007; also see Chapter 2, section 2.3.1). Hence, North (1990) argues, even if new formal institutions are established, the delay of change in informal rules and culture may still weaken the new rules, since people may simply ignore the formal rules. Thus, lax enforcement of formal institutions by man is one reason why *guanxi* could affect formal bank management. It is also seen from the research findings that some dishonest bank officials, with a view to gaining their personal interest and minimising their risk, would take advantage of the loopholes of regulations and make their own profits by helping unqualified borrowers. According to the book edited by Turner *et al.* (2015: Chapter 4, written by R. Kent Guy), the choice between 'rule of man' and 'rule of law' is sometimes identical to the choice between personal gains and justice, but I consider that it is also about the choice between informal and formal institutions. From the literature referred to here and in Chapter 3, it can be seen that in China, the ideology of 'rule by man' has always taken precedence over 'rule by law' culturally and institutionally.

To ensure that every bank official has the freedom to deal with complicated and changeable problems, the bank offers them some autonomy with an appropriate opportunity to exercise power. It was found in this research that the root cause of people choosing latent rules is the trade-off between profits and the risk of the potential costs of default. Bank leaders and LMs are the executive authorities of the bank and have the right to deal with the bank's lending transactions. An executive authority is not only a representative of its bank who has the discretionary power and should wholeheartedly create value for the bank, but also an independent individual who will make a comparison between "ego" and "super-ego" in the administrative process for his own interests (Freud, 1962: 13; Rennison, 2015). The research findings show that many of them abandon the "super-ego" and choose the "ego", resulting in the abuse of power and the pursuit of personal interests. Choosing the "ego" here means that the bank official behaves selfishly and does everything to maximise his own interests and minimise the risks, while the choice of the "super-ego" means that the bank official will behave with integrity and always consider the bank's profit as a priority. Once the ego is chosen, bank officials might seek personal gains under latent rules by exercising their

discretionary power. In banking industry, bank leaders are the highest authority of the bank and the decision makers; although there are formal institutions in the bank, it is known from Chapter 5 that bank leaders still have overall control of the bank. When formal rules are against their own interests, they will ignore or bypass the "rule of law" and turn to the "rule of man" for their own egoistic purpose. Without the drive of practical interests, latent rules would probably not emerge. Objectively, interest-driven egoism is another fundamental influence of latent rules in SME lending. In practice, when the application of latent rules leads to far greater profits than the risk costs, people will choose to use latent rules and find ways to bypass and deviate from formal rules. The result of ignoring formal rules might be corruption in the form of *guanxi,* such as LMs accepting false financial statements in their own interests, and bank leaders approving unqualified lending due to *guanxi*. According to Wu (2001), the 'father' of the latent rule, the purpose of latent rules is to achieve interests that are difficult or impossible to achieve through formal rules. He considered that no formal rule is able to accommodate all social relations, and since the formal rule has general procedural regulations, it lags behind the latent rule in terms of efficiency in safeguarding personal interests. However, latent rules can generally solve a problem more efficiently and quickly, and less energy input can lead to the same or even greater outputs (Zhang and Zhang, 2006), thus meeting people's needs of achieving their interests rapidly, and giving them great satisfaction. At the same time, when people have fulfilled their own needs and realised their own interests by adjusting formal rules, they are willing to show off these 'achievements' to others. At this point, their interests will reversely incentivise individuals to choose latent rules, and more people will imitate this behaviour to satisfy their own needs (Wu, 2001; He, 1998). This also explains why bribery of LMs was a very common phenomenon in 2008 and 2009, and people who did not accept 'gifts' were considered "asocial" (see Chapter 7). To a certain extent, latent or informal rules could fulfil humans' utilitarian purposes, and the insurmountable weakness and complexity of human nature determine the inevitability of latent rules (Lovett, 1999; Luo, 1997; Hsiung, 2013; Park and Luo, 2001).

After understanding this background (informal rules are more flexible and efficient than formal rules and justice in pursuing personal profits) in China, and based on Wu's (2001)

argument above as well as the embeddedness theory, it can be concluded that, to some extent, SME lending in China is embedded in informal rules like *guanxi*, since it is more convenient for both LMs and SME managers to pursue their own interests by applying informal rules rather than formal ones. The common acceptance of manipulated financial statements (shown in Chapter 4) is a good example of this. LM4 indicates in Chapter 4 that creative accounting or window dressing is also commonplace for listed companies in China, only they may do it 'legally'. As discussed in previous literature (Xuan, 2002; Chen *et al.,* 2011a), many listed companies can still fabricate their accounts 'creatively' within the regulations. Even when accounting frauds occur, some firms, particularly SOEs, are still protected well by the local government officials, since their performances can significantly affect the reputation of the local governments and are also related to the assessments of local government officials' work performance (Chen *et al.,* 2001; Chen *et al.,* 2011a). Thus, although there are regulations (issued by higher authorities such as the central government), some local governments may still allow false information to be presented. In addition, it is also revealed in Chapter 4 that the current situation in China is that false and unreliable information is indeed applied in enterprises' operations, resulting in the ineffective enforcement of laws. In Chapter 4, LM4 talks about listed companies because he wants to highlight that ordinary SMEs' accounting information is much less trustworthy and reliable in China than it is in Western countries. In addition, the findings in Chapter 4 show that LMs and SME managers are well aware of this situation (SMEs' financial statements are false and not trustworthy), while banks still accept them as proof for lending, and wish to lend as much money as they can be. One incentive of this phenomenon is interest (banks want to make profits and bank officials also want to pursue their own interests) and it is also shown in the later empirical chapters (see Chapters 6 and 7) that another reason is *guanxi*. *Guanxi* can influence government officials or bank officials to choose the "rule of man" and accept these false statements, since those who apply it can gain interest from it. The interest-driven aspect also means *guanxi* is used as a tool to achieve egoistic goals here, which is also why *guanxi* as an informal "rule of man" could play such an important role in the area of SME lending. When it was difficult to seek personal gains through execution of formal rules in the concept of "rule of law", the research findings show that people would apply latent rules as if by prior agreement, provided that this

application of latent rules in the concept of "rule of man" brought both low risk and high profit (or the loss of risk are lower than the gains from profit). Traditionally, on the basis of kinship over rite, the Chinese are accustomed to contacting each other for the main egoistic purpose of seeking personal gains through human relationships (*guanxi*). When exchanges are carried out with others on the basis of *renqing* and interest, one would consciously or unconsciously ignore the formal rules (He, 1998). Accordingly, formal rules were gradually weakened, since latent rules such *guanxi* could help people make profits with much greater efficiency than formal rules could be expected to do. This is proved by the research findings, as, otherwise, those unscrupulous bank officials would not take the risk of accepting false statements.

8.3.3 Unsound institution supervision system

Furthermore, insufficiently strong supervision of regulations during the social transformation period is another reason why *guanxi* could affect bank management. Power *per se* is lawful, but we have to consider how to control it properly, make those who hold power maintain integrity, and prevent estrangement between power and power holders. Under informal rules, breaches such as rent-seeking and the abuse of power for personal gains are likely to be committed (He, 1998). However, it will be difficult for such breaches to be brought to light if they are not punished appropriately by law. With this collusion, offenders will take the risk of continuing to challenge the law authority, thus making it difficult to eliminate latent rules. As the interviewees said in Chapter 4, when bad loans occur, if everything looked fine 'on the surface', this means the LM could offload the responsibility, and thus they would not need to risk any legal liabilities. Their punishment might just be a reduction in salary. So, if they could eliminate their own risks and earn more, why would they be afraid of helping unqualified SMEs? From the standpoint of SMEs, they could simply file for bankruptcy if they were not able to repay the loans, and, as some SME managers said, they could even establish a new enterprise after the bankruptcy. Hence, the default cost is very low and people are not afraid of behaving badly. As discussed previously, the root cause of latent rules is the trade-off made between profits and risk costs. Thus, if the profits exceed the costs, then many people would choose latent rules rather than follow formal

rules. This is also one reason why *guanxi* as an informal rule could exist and play its part in SME lending, showing the importance of sufficiently strong supervision, if the supervisory authority strengthens supervision to an extent that raises the risk and cost of latent rules, people will consider whether such behaviour is beneficial to them instead of heedlessly following latent rules.

The difficulty in tracking cash flows is also due to the invalid supervision system; since the accounting system is not perfect in China, enterprises in China are not obliged to use corporate accounts when doing business. As LM2, LM5 and other loan managers mention in Chapter 4, and LM1 also asserts, SME managers always use their personal accounts to do businesses, rather than using the corporate accounts to transfer or accept money. This leads to the problem that financial institutions are not able to track the enterprise's cash flows through its corporate account statements. LM1 considers that this is due to the imperfect design of institutional accounting regulations and the imperfect accounting supervision system in China, which mean that not all financial data need to be recorded in the financial statement. This gives the SME manager a space to manipulate the statement and makes it more difficult for financial institutions to track or verify SMEs' real cash flows according to financial statements only, so that banks are not able to verify those not in the statements. This objectively leaves room for the survival of latent rules, and some SME managers just use this loophole to avoid the monitoring, the situation that SMEs provide different versions of financial statements to different organisational bodies may even happen, leading to other illegal activities such as tax evasion. In an example provided by LM5 in Chapter 4 (sub-section 4.2.2), in order to evade tax, the SME manager may not record all the sales data in the financial statement which is provided to the tax bureau. However, in order to obtain more loans, they might provide a different financial statement with a higher annual turnover to the bank, since the maximum loan amount is related to the annual turnover. This situation leads to the inaccuracy of Chinese SME's accounting information, so that Chinese LMs are not able to obtain the valid information they want from financial statements, resulting in the situation that LMs do not trust these statements. And this ultimately finally leads to the positive application of a *guanxi* investigation by the bank

management, since non-financial information and informal rules such as *guanxi* could provide more valid information.

The real-life example provided in Chapter 7 is another example showing the effect of *guanxi* in an insufficient formal institution supervision environment. The emergence of this situation is partly due to the bank leader's utilitarian considerations but, more importantly, because of *guanxi*. This is only because the unqualified borrower had a good *guanxi* with the government official, and since the bank is under the constraint of government administration, such that the *guanxi* with a local government official could affect the final lending decision. Otherwise, without it, the lending decision would not be made in the borrower's favour and he would not be able to obtain the loan. Indeed, the most important element here may not be the *guanxi* itself, but rather, the local government official or the environment. It is true that *guanxi* made this transaction happen, but if the government official had adhered to the law strictly, or there was a very strong supervision system that obliged him to do so, then this would not have happened and *guanxi* may no longer be important in this case. Thus, *guanxi* plays the role of 'catalyst' here, meaning it could lead to the lending transaction but may not be central to it.

Generally, insufficient supervision of regulations and the application of informal rules such as *guanxi* mutually affect each other. *Guanxi* is embodied in the imperfection or insufficient supervision of formal institutions, and formal institutions are also affected by *guanxi* and the culture behind it. It is because that the formal institution system in China has many deficiencies, such that *guanxi* is used here to amend this "imperfection" to some extent. However, perhaps paradoxically, the widespread application of *guanxi* might also exacerbate this "imperfection" from the "dark side". In conclusion, as can be seen from the discussions in this section, the existence of informal rules such as *guanxi* that have an impact on the bank management and lending in China is not a coincidence, but a necessity.

8.4 Summary

Having been followed until now throughout China, *guanxi* has been a part of Chinese traditional culture, it is everywhere in Chinese society and embodied in every Chinese's daily social contacts and etiquette, and which will not disappear within a short time. Unlike formal rules which are severe in terms of worldly wisdom, latent rules such as *guanxi* have a harmonising effect. *Guanxi* acts as a "tranquilizer", resulting in social stability which creates a harmonious social environment to facilitate the steady development of society, and enhance mutual relationships and trust in SME lending. Therefore, the role of *guanxi* in SME lending cannot be ignored, and the purpose of this thesis is to explore it. This chapter explains how *guanxi* plays its part in SME lending from cultural and institutional perspectives.

Section 8.2 first discusses why *guanxi* as a latent rule could affect lending from the cultural and instrumental perspectives. The discussion focuses on the shift of *guanxi* from a cultural tradition to social capital by analysing the *guanxi* structure (three dimensions and six features). The 'indirectness' feature is a newly explored concept, which derives from the empathy feature and Confucian social norm. This research uses some empirical examples to show the manifestation of this feature in SME lending, and explains the behavioural logic of Chinese people which lies behind it, which helps to gain a better understanding as to why *guanxi* can play such an important role in this process. Section 8.2.2 is the most important sub-section here, as it identifies that the basic hypothesis of embeddedness theory is supported empirically and offers an explanation as to why it could be applied in the Chinese context. The hypothesis, which is reflected in the 'customer introduces customer' phenomenon in China is in fact transferring the *guanxi* and *xinren* (trust) behind it. In addition, two types of 'common friends' (direct and indirect CF) *guanxi* which are used to investigate SME managers are proposed in this sub-section. The application of CF *guanxi* in SME lending identifies the functions of strong ties and weak ties from the embeddedness theory, and it was found that indirect CF *guanxi* uses a weak tie as a 'bridge' to transfer information and strong ties as 'bridge piers' to support the 'bridge'. Compared to Granovetter's (1973; 1985) embeddedness theory, it is found in this research that although strong ties might not be responsible for the transfer of information, they are also very important since

they are the foundations of the 'bridge'. It is also supported empirically in this research that the "forbidden triad" situation mentioned by Granovetter (1973: 1363) would not arise. Furthermore, it is shown in the empirical data that a weak tie could become a strong tie and create trust between the participants after the lending and many interactions have taken place. In conclusion, the discussions in this sub-section identify the embeddedness theory, fill some of the gaps in it and extend it theoretically and empirically, which is one of the major contributions of the research. It is found in this sub-section that *guanxi* based on the reciprocal feature could affect the lending, since reciprocity is a traditional social norm and obligation commonly followed by Chinese people. Many bank officials make the lending decision due to a *renqing* exchange, which is based on reciprocal courtesy. Moreover, it offered an empirical example about how favours and *renqing* are transferred in a bilateral circulation, showing how Chinese *guanxi* works among the participants in the SME lending area. It was found in sub-section 8.2.3 that *guanxi* could be either utilitarian or emotional, but there is a trend for the utilitarian feature to turn *guanxi* gradually into an instrumental social capital, which could bring benefits for those who use it. For example, acquaintance *guanxi* is used as a social capital by LMs to control risks, and SME managers also use it to secure loans as well as to reduce policy uncertainties. It is also presented here that a *guanxi* circle is exclusive since it is easy for the members of the circle to obtain internal information while it is difficult for non-members. Furthermore, a *guanxi* circle and long-term *guanxi* could place the participants in a 'lock-in' situation. That is, the longer the period of cooperation, the more difficult it is for the participants to quit, meaning that the participants would even rather pay higher costs in order to maintain this stable relationship, which supports North's theory (1990 and 2005). Therefore, *guanxi* as a social relation, a cultural tradition and a social capital could affect SME lending, meaning that economic behaviours such as SME lending are culturally embedded in *guanxi* in China.

Secondly, section 8.3 explains how *guanxi* substitutes for formal institutions to a certain extent, affecting the lending indirectly from the institutional perspective. Sub-section 8.3.1 shows that it is the unsound formal institutions and institutional defects that have made informal rules important in economic activities. Since China is in a transition

period, and the development of formal institutions have not been able to keep pace with the development of social practices such as the economy and the market, when formal rules lose their functions, informal rules play a role in supporting economic behaviours. Sub-section 8.3.2 explains that the inconsistency in the development of formal and informal institutions would also weaken the new rules, since China is a country that adheres to its traditional culture, social norms and ideology, meaning that informal rules are rooted deeply in Chinese society, but the new formal ones are not. So "rule of man" is always prior to "rule of law". In addition, interest-driven egoism also weakens formal rules. Since informal rules are more flexible and efficient in pursuing personal profits, people prefer to follow these informal rules but rather than the formal ones, resulting in the lax enforcement of formal institutions by man. Sub-section 8.3.3 explains the third reason why *guanxi* could be a supplement to or substitution for formal institutions; this is due to the unsound supervision system in China. With a stronger supervision system, latent rules such as *guanxi* would probably not play such an important role in economic activities like SME lending. Finally, this section concludes that the existence of *guanxi* affecting bank management and lending in China is not a coincidence, but a necessity during the social transformation period.

In conclusion, based on the embeddedness theory, institution and institution change theory, it is proposed in this chapter that economic behaviours such as SME lending are both institutionally and culturally embedded in *guanxi* in China, which means *guanxi* could affect lending decision-making. The next chapter provides the conclusion of this whole thesis.

Chapter Nine: Conclusion

9.1 Introduction

Following the presentation of the background of the Chinese SME financing and financial system in Chapter 1, this thesis proposed the motivation for the study and main research question: If SMEs' accounting information and their financial statements are not trustworthy and reliable, then how do SMEs obtain loans in China? In order to answer this main question, three sub-questions are asked in Chapter 2. These are: (1) What is the current accounting information environment in China, and what are the causes and incentives of this environment? (2) How do Chinese financial institutions such as banks conduct evaluations of Chinese SMEs in order to make lending decisions, and what factors will affect the lending decision-making? (3) What precise role does *guanxi* play in SME lending exactly and how does it affect lending from a cultural and institutional perspective? In order to address these questions, apart from the review of the previous literature, three rounds of fieldwork were conducted to collect research data. As an interpretivist social science research, ethnography, participant observation and semi-structured interview methods were used in the data collection. In addition, a new sampling method, *guanxi*-oriented snowballing, was used to sample the research interviewees, and thematic analysis and Framework Analysis (FA) approaches were adopted to analyse the research data subsequently. Moreover, the Confucian philosophy and the cultural roots from which *guanxi* is derived and the historical changes in informal rules in China are also introduced in Chapter 3. These are important since they are the foundations of understanding *guanxi* in the Chinese context culturally and institutionally. This chapter will draw conclusions from the empirical research findings and contributions by answering the research questions, then presenting the theoretical and methodological contributions, and finally, the implications and limitations of this research.

9.2 Research findings and contributions

Chapter 4 mainly concerns answering the first research question. It is shown in Chapter 4 that accounting information is not that trustworthy, financial statements are not reliable and the accounting environment is poor in China. The findings reveal that there are two apparent causes of this environment: the difficulty in tracking cash flows validly and the limitations of the rights of banks and loan managers (LMs), which are due to the imperfect system of accounting management and supervision in China. It is also confirmed in this chapter that both banks and SMEs are aware of this environment, they know that financial reports are invalid and inaccurate, but there are three main incentives for them to accept this situation: the profit-making incentive, the performance evaluation system, and overly stringent formal rules. These incentives are all interest-driven, and the last also reveals another important reason why Chinese SMEs cannot obtain adequate funds, since they would not normally qualify for loans due to these overly stringent formal lending rules. Therefore, in order to obtain loans, they have to take risks by providing false statements, and which exacerbates the situation and results in a vicious circle. In addition, while a considerable body of accounting research focuses on the importance and usefulness of financial information in the lending process, the findings in this paper indicate that financial reports may not be as important as they may appear in SME lending in China. Their importance may be attached only to the legitimacy they provide, rather than because they can provide very useful information.

Given that accounting information is inaccurate and invalid, Chapter 5 explains which kind of non-financial information Chinese financial institutions collect, and then how to conduct loan evaluation and approval with valid information. Firstly, it is found in this chapter that LMs use various ways in the field to collect information about their SME customers, such as 'walking around the enterprise and asking the workers questions', rather than simply looking at financial statements off the field. Secondly, it shows that non-financial information is very important in reflecting SMEs' true conditions, and that there are two main non-financial factors that concern LMs when making a lending decision: the SME manager's circumstances and SME's 'production and operation condition'. Thirdly, after the collection of information, LMs will analyse

all the collected information and evaluate the enterprise, details of which are presented in section 5.2. Finally, it was found that, although Chinese banks use formal regulations and credit review department (CRD) to make loans, it is still the loan staff who evaluate and make the final lending decisions.

Chapters 6, 7 and 8 answer the third research question and its sub-questions. What are the functions of *guanxi* in the process of Chinese SME lending? It is explained in Chapter 6 that there are three functions of *guanxi* in the lending process. The first function is that *guanxi* could be used as a tool to develop and maintain customers for financial institutions such as banks. In order to achieve this, it was found that the establishment of *guanxi* is the first step and that the entry point is very important, which means that there are some specific informal ways to establish *guanxi* between LMs and potential borrowers. For example, LMs are supposed to chat about irrelevant things first and then move on to the lending business, in order to make this process more comfortable, 'warm' and humanised. Otherwise, it will be considered rude and will be anathema in Chinese culture. The findings show this informal rule also improves the *xinren* (trustworthiness) between the participants. Furthermore, the findings show that customers are maintained through long-term and continuous *guanxi* by LMs. The second function of *guanxi* is to control lending risks. LMs can obtain more information about SME managers by making friends and maintaining *guanxi* with them, information which is important in estimating and controlling risks in the lending. SME managers could also use this *guanxi* to secure loans and reduce policy uncertainties, since LMs may tell them in advance about bank policy changes which may affect the loans. Hence, the role of *guanxi* here is to reduce risks and benefit both parties. The third function of *guanxi* is that it could be used as a method for investigation in the forms of direct and indirect 'common friend' (CF) *guanxi*. The findings show that these two forms of *guanxi* are very important methods commonly used by Chinese LMs in investigating SME managers, particularly given that accounting information is useless. The definitions of CF *guanxi* are presented in the summary of Chapter 6, and discussed further in Chapter 8, section 8.2.2.

Does *guanxi* help improve access to credit for Chinese SMEs? Could it reduce the cost of credit or requirements of financial institutions for SMEs? Could it reduce malfeasance problems? In Chapter 7, the first research finding is that acquaintances have more advantages than strangers in terms of the availability of credit; banks may even reduce some lending requirements (i.e. require less, or even no collateral) for acquainted borrowers, since acquaintance *guanxi* (as a high level *guanxi*) which is built through long-term interactions could generate *xinren* (trust) among the participants. This corresponds precisely to the key concept of Granovetter's (1985) embeddedness theory (see Chapter 2), which emphasises that strong ties (through frequent interactions of social relations) could generate trust and affect economic behaviors. Moreover, the findings in this section show that lending to acquaintances could reduce investigation and negotiation costs for banks. It was also found that although SME managers probably need to pay more interest, they could also save search or negotiating costs when dealing with acquainted LMs, since the loans are secured if they have this acquaintance *guanxi* with the bank. Furthermore, acquaintance *guanxi* functions not only for one lending transaction, but also for further cooperation, which this could bring a sense of safety to the participants, reduce the crisis of confidence between banks and SMEs, and alleviate the information asymmetry problem, which also confirms other elements of the embeddedness theory[17]. Therefore, in conclusion, trust is embedded in acquaintance *guanxi* and could reduce malfeasance in economic behaviours such as SME lending in China, and high-level *guanxi* could affect lending decisions. This also represents an empirical contribution to the embeddedness theory. In addition, it was found in Chapter 7 that acquaintance *guanxi*, as a strong tie, could also generate *ganqing* and *renqing* among participants. *Renqing* is a kind of social capital, and *renqing* exchange based on gift-giving is a kind of social norm or custom in China, which ensure that *guanxi* could indeed affect economic behaviours. This is a further empirical finding.

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[17] "(1) if the actor wants to maintain this continuing relation, he would have the economic motivation to show his trustworthiness to the counter-party, otherwise, future cooperation will be affected; (2) this 'continuing economic relation' could bring confidence and satisfaction in their social relations, which makes the participants expect trust behaviors but not opportunism (Granovetter, 1985: 490)." (See Chapter 2).

Does *guanxi* have a positive or negative impact on the lending process? Could it exacerbate malfeasance problems? In addition to the above empirical findings and contributions, it is also identified in this research that *guanxi* has both positive and negative outcomes. Lovett *et al.* (1999) consider that *guanxi* is not only about bribery and corruption, while other researchers (Gu *et al.*, 2008; Chen *et al.*, 2013) find it has both positive and negative effects. Chen *et al.* (2013) examined previous literature on *guanxi* and found that it could act in effect as a double-edged sword in economic life. It is identified in this research that *guanxi* has some positive effects, such as assisting banks to obtain more internal information about borrowers, resolve the information asymmetry problem and reduce banks' risks. It also has functions such as being used to find new customers and investigate borrowers. It could also smooth the lending process for SMEs and help them obtain loans more easily. However, most of the prior literature focused on the positive aspect of *guanxi*, so they encouraged further researchers to pay more attention to the negative outcomes of *guanxi* and to "test the double-edged hypothesis of *guanxi* function" (Chen *et al.* 2013: 197). This present research makes a contribution to knowledge by answering this call and therefore assisting in filling this gap. There are some negative outcomes shown in Chapter 7; for example, acquaintance *guanxi* could result in a 'lock-in' situation and lead to the information-rent seeking problem (see also Chapter 8). It also shows *guanxi* could lead to some corrupt behaviours through gift-giving and that these could affect the final lending decision. In addition, in the real-life example given in section 7.5, the bank leader who was concerned about his future career development and under pressure from a government official, still decided to lend to an unqualified borrower. This example also resolves the debate as to whether if *guanxi* still has a significant impact on lending decision-making (Chen *et al.*, 2011b; Wu, 2008: Selmier, 2013) and supports Chen *et al.*'s (2011b) finding that *guanxi* with government or government officials could still affect lending decision-making in certain areas. Based on Granovetter's (1985) embeddedness theory, it is also demonstrated in Chapter 7 that *guanxi* as a social relation not only could generate trust between the actors and reduce certain malfeasance phenomena, but could also lead to greater malfeasance, since good *guanxi* between LM and SME manager is a social resource, which could allow the LM to accept fraudulent financial statements or help the SME manager obtain a loan. However, there may also be other purposes (e.g.

the LM's own egoistic considerations such as earning more income or further career development) involved, which is the dark side of *guanxi*. In conclusion, although *guanxi* is invisible and intangible, it is revealed this thesis that *guanxi* plays an important role in the bank-SME lending area.

How does *guanxi* affect lending from a cultural perspective? It is discussed in Chapter 8 that that SME lending is both institutionally and culturally embedded in *guanxi* in China, which means *guanxi* could affect lending decision-making. Based on previous *guanxi* literature, this thesis develops a *guanxi* structure with three dimensions and four features, which is used to analyse *guanxi* in SME lending. Moreover, it could also be used by future further researchers to analyse *guanxi* in other economic behaviour. Through the development of this structure, this study makes theoretical methodological contributions. Based on the cultural roots and background of *guanxi* shown in Chapter 3, this research has identified and extended previous literature about *guanxi* features by providing empirical examples. In addition, in terms of theory, it also proposes two new *guanxi* features, which are the indirectness and exclusiveness features. In Chapter 8, the discussion of how *guanxi* affects lending culturally and instrumentally is conducted through the testing and analysis of six features with empirical examples. The indirectness, empathy and reciprocal features, which derive from traditional Confucian social norms, show the behavioural logic of Chinese people in conducting economic activities. For example, the reciprocal feature shows that it is because that bank officials adhere to the reciprocity norm of *renqing* transfer and exchange, namely, *renqing shigu (人情世故)* that makes them agree with the lending, and finally affects the lending decision. The discussion of utilitarian features shows that interest-driven utilitarianism and egoism are the core incentives for individuals' application of informal rules and *guanxi* in SME lending. The discussion of the exclusiveness feature shows that *guanxi* has gradually evolved into an instrumental social capital that helps group members gain resources and benefits inside *guanxi* circles. Therefore, *guanxi*, which has been part of Chinese culture for a very long time, has in recent years come to be a tool for people who use it to further their interests in economic activities such as SME lending.

The discussion of the transferable feature also reveals some theoretical contributions of this research. Firstly, based on the analysis of the 'customer introduces customer' phenomenon, it identifies that the basic hypothesis of embeddedness theory does work empirically and offers an explanation as to why it could work, since it actually transfers *guanxi* and *xinren* (trust) under Chinese context. Secondly, based on the analysis of the application of 'common friends' (CF) *guanxi* in investigating SME managers, this research identifies the functions of strong ties and weak ties from Granovetter's (1973; 1985) embeddedness theory. In practical terms it also explains facets of strong ties and weak ties in the Chinese context in the SME lending area, which Granovetter's theory might not be able to explain fully. It was found in this research that indirect CF *guanxi* uses weak ties as a 'bridge' to transfer information. Moreover, it extends embeddedness theory by finding evidence to conclude that although strong ties might not be responsible for transferring information, they are also very important since they are the foundations of the 'bridge' and are therefore 'bridge piers'. Hence, it is identified in this research that information could be transferred through weak ties, but more importantly, it is because *xinren* (trust) as part of *guanxi* is transferred through strong ties which makes this happen. Lastly, it is supported in this research empirically that the "forbidden triad" situation mentioned by Granovetter would not occur (Granovetter, 1973: 1363; also see Chapter 8). The aforementioned are among the theoretical contributions of this research, and in turn, these contributions also enhance the importance of the role of *guanxi* in SME lending, as *guanxi* is widely used and plays an essential part in this process.

How and why could *guanxi* affect lending from an institutional perspective? The answer to this question focuses mainly on the discussions of formal institutional deficiencies, which comprise three main aspects: unsound formal institutions, insufficient enforcement of formal institutions and an unsound supervision system, resulting in informal rules supplementing or substituting for these formal institutions. Firstly, since China is undergoing a transition period, formal institutions cannot keep pace with the economic change; therefore, it was found in this research that when formal institutions cannot promote the development of banks and SMEs, they will turn to the application of informal rules to bypass these unsound and unreasonable formal rules. For example,

due to strict lending requirements of banks, SMEs provide false financial statements and use *guanxi* to fulfil banks' requirements and obtain the loan, which makes these formal regulations only nominal. Such formal rules are also the reason why informal rules like *guanxi* can play a part in SME lending. Secondly, since the development of informal rules and culture cannot keep pace with formal institutional change, the ideology "rule of man" still takes precedence over the "rule of law" in China, so that the enforcement of formal rules is inefficient. In addition, it was also found in this research that interest-driven egoism also exacerbates this situation and weakens the formal rules. Because informal rules are more flexible and efficient in pursuing personal profit, some unscrupulous bank officials and SME managers prefer to follow informal rules rather than the formal ones. Thirdly, it was found in this research that the insufficiently strong supervision of formal institutions leaves room for informal rules and *guanxi*. For example, the unsound accounting supervision system leads to difficulty in tracking corporate cash flows, which makes financial statements invalid, so that LMs have to use informal rules and *guanxi* to investigate SME managers as these could provide more valid information. Hence, financial statements are replaced by *guanxi* in discovering the conditions of SMEs. The discussion about the real-life example (presented in Chapter 7) shows that *guanxi* probably would not be able to play such an important role in SME lending if there was a stronger supervision system of formal institutions. However, the fact is that there is not, and "Consequently, *guanxi* […] play[s] an important role in such a dynamic environment as that of China" (Zhang and Zhang, 2006: 385).

The answers to the above questions make several contributions to the literature and to theory, and are also the empirical contributions of this research. In addition, this research proposes a theoretical framework that contains elements of Mark Granovetter's embeddedness theory and Douglass C. North's institution and institution change theory, extending new economic sociology and new institutional economics research areas. It is discussed in Chapter 8 that interest-driven egoism is one big factor that could affect lending, meanwhile, this research states that *guanxi* as a culture tradition, social capital and informal rule could also affect the actors' economic behaviors, and discusses why it could affect the lending decision-making and credit availability of SMEs from a

cultural and institutional perspective. This thesis also focuses on culture and informal institutions and emphasises their importance in social embeddedness research, as well as showing that culture and informal institutions could have great impacts on economic behaviours such as SME lending, thus extending the embeddedness theory theoretically and empirically. This research also makes other contributions of this research. For example, a new data collection method, *guanxi*-oriented snowballing (Kriz *et al.,* 2014) was used to collect data in this research. The greatest difference between *guanxi*-oriented snowballing and normal snowball sampling is the strength of relationships among the participants. Normal snowball sampling does not have any requirements as to the closeness of referrers and referrals, while *guanxi*-oriented snowballing is based on *guanxi*, which means that there normally exists a high level of relationship between the referrers and referrals. According to the literature in Chapter 2 and as discussed in Chapter 8, the researcher can inherit the *xinren* (trust) underlying the referrer and referral's *guanxi*, which means that the *xinren* (trust) can be transferred from the referrer to the researcher, so that the referral interviewee would also trust the researcher, feel more relaxed and wish to provide more valid information. The referrer plays the role of 'guarantor' to ensure the safety of the interview for the referral interviewee. This is therefore an advantage and contribution of the *guanxi*-oriented snowballing method in collecting research data in China. Another methodological contribution to the literature of this research is that it reveals the foundation and nature of *guanxi* by presenting the cultural roots and historical institutional changes of informal rules, explaining the cause of formation of *guanxi* since ancient China, how it changes with the institution changes in modern China, and showing that *guanxi* is deeply embedded in Chinese culture and society.

After providing these empirical findings and contributions to answer these research questions, the main research question regarding how SMEs obtain loans in China, is also answered here. Briefly, given the situation that accounting information is inaccurate and invalid, the investigation of Chinese SMEs is heavily dependent upon non-financial information, and *guanxi* plays an essential role in the lending process; it is a "lubricant", a 'catalyst' and a harmoniser, and could affect the lending culturally, instrumentally and institutionally.

9.3 Limitations

There are several limitations of this research. The first limitation is the language difference or barrier. Language has the key responsibility of interpreting meanings in qualitative research (Nes *et al.,* 2010). English is considered as the dominant academic language in western countries (Kushner, 2003), while in cross-language and cross-cultural research, language differences could cause a 'language barrier' and lead to loss or distortion of research data in the translation process (Squires, 2009: 277; Nes *et al.,* 2010). Moreover, it is not only about the difference between Mandarin and English in this research, since there are also some local dialects involved. It is inevitable that some meaning will be lost not only after the translation from Chinese into English, but also after the transcription from voice records (including some local dialects) into the Chinese context (Mandarin). Therefore, in order to reduce these losses distortions and biases as much as possible, and make sure all the meanings are interpreted and transferred accurately to the readers, the researcher took more than one year to carry out the transcription and translation tasks with great care. The researcher had to listen to every sentence of the voice records several times, transcript them into Mandarin texts first, and then translate all the quotes into English properly. This process was not just about plain transcription or translation but involved deep thought about the meanings and logic behind the contents. In addition, the researcher has tried to translate and present the data in an English rather than Chinese logic. However, also because the researcher is not a professional English-Chinese translator, bias was still inevitable due to the linguistic and cultural difference. Hence, there may exist a certain bias in some places, particularly in the chapters in analysing the empirical research data.

The emphasis of this research is on showing the importance and function of non-financial information in the lending process, and informal rules like *guanxi* in solving the information asymmetric problem when financial information fails. So in order to focus more on the importance of non-financial information and informal rules in this thesis, there is little discussion on financial information or formal institution *per se* here. The researcher has deleted some sections of Chapter 5 in order to make it less tedious

and focus more on the emphasis explained before, but the limitation is that it may make the chapter less comprehensive than could be ideally wished in terms of explaining the second research question (see Chapter 2). Many LMs consider that financial statements are not reliable (see Chapter 4), and that non-financial information can reflect the truth more than financial information can (see Chapter 5). However, this does not mean that none of the financial factors is important. LMs also try to verify some financial data from statements such as the annual sales or incomes of SMEs in specific ways. So the deleted sections concerned how LMs verify these financial data in a 'non-financial' way, the methods or procedures that LMs use to collect their own financial information and identify the truth of these accounting data about SMEs, but not just by reading the numbers on the financial statements. These are also parts of the answer of the second research question about how Chinese financial institutions make the lending decisions, but they are not the main concern of this thesis, so they are deleted here. The researcher may add this to form a separate paper which is about *'Financial information reporting and loans to Chinese SMEs'*, but not address it fully in this thesis.

The third limitation is the sample size. Since the five informal interviews conducted during pre-understanding fieldwork time are not included in the sample, there are only twenty formal interviews (including two pilot interviews) in this research. Although the data collected are very rich and of high quality, the sample size might still be too small for a social science research. In order to mitigate this limitation to some extent, the participant observation method is also used in collecting relevant data, and field notes and reports have been written to enhance the richness of data. However, due to the small amount of sample size, there are still some shortcomings, for example, the real-life example presented in Chapter 7. Although it could reflect certain realities and some other interviewees also mentioned similar situations, it still might be an exceptional case and not that representative. Since from a scientific perspective, it is the only specific case mentioned by one interviewee in detail in this research. Hence, further research is necessary to provide more empirical examples to support the example in Chapter 7. Another limitation following the sample size is the regional and industrial distribution of the participants, as most of the SMEs involved in this research are manufacturing

SMEs in eastern part of China. Although these SMEs are highly representative of those of the whole country, the researcher still hopes to do more interviews in different Chinese regions and involve more types of SMEs in subsequent research. Moreover, the researcher could use the *guanxi* structure and theoretical framework (presented in Chapter 2) as a kind of 'theory', add some quantitative research methods such as questionnaires in future research, to 'quantify' the effects of *guanxi* in SME lending and then measure how *guanxi* could affect lending decision-making in a quantitative way.

9.4 Implications

According to the sociologist Emile Durkheim, during a period of social transformation when old standards and norms have disintegrated and no new standards and norms have been established, in the absence of norms for personal desires and behaviours and good institutional arrangements, society is in an abnormal condition of social anomie, thought of as 'normlessness' (Durkheim, 1951 and 2014; Marks, 1974; Slattery, 2003: 23). China is currently in a critical period of social transformation from the original closed society to a more open society. In the period when the old system is transforming into the new one, it was found in this research that the concept of a formal legal system has not yet become mature in the society and the "rule of law" is still in progress, so that the formal institutions are replaced to some extent by informal rules. Thus, based on Durkheim's theory of anomie, during the process of transformation in China from an agricultural society to industrial society, from a relation-based society to a rule-based society (Li, 2004), social anomie is unavoidable to a certain extent. In the SME lending area, there also exists some 'economic anomie' phenomena (Marks, 1974: 331) exemplified by accepting false financial statements against the formal rules, securing loans through *guanxi*, the abuse of "gift-giving" and so on. Although there are many social or economic anomies presented in this thesis, the main purpose is not to show how dark the situation is in China, but rather, to reveal the problems, face them and help to solve them. China is still developing and in a very specific transition period. I think if we do not have the courage to face these problems but ignore them, then the problems will never be solved, and the improvements will never be made.

Durkheim (1951 and 2014) considers anomie in modern society mainly arises out of increasing selfish desires and absent moral regulation; that is, modern society is faced with a considerable moral crisis. It was also found in this research that interest-driven egoism and utilitarianism are the core incentives of economic anomie in SME lending. Therefore, rebuilding social order implies rebuilding moral rule to play a regulatory role, and morality could restrain selfish desires (Durkheim, 2014). Durkheim's emphasis on the moral norm has the same purpose as traditional Confucianism. Confucianism, as represented by Confucius, also attaches importance to personal moral virtue (see Chapter 3). However, we should realise that the existence of latent rules and economic anomie involve not just moral decay, but reflect great defects within the whole system, so what we should focus on is removing the institutional defects instead of depending only on the improvement of individual moral qualities. We should also care more about institutional loopholes and drawbacks of the Chinese legal system, which also includes the banking industry. In the unique dynamic cultural and economic transition environment of China, *guanxi,* which is treated as a latent rule and social capital, plays an essential role in the SME and bank lending process. It was found in this research that the existence of this situation is partly due to the unsound supervision system of banks, as well as the excessive administrative constraints imposed on enterprises by the government. China has achieved a remarkable result in terms of the transformation from planned economy to socialist market economy, but the government is still in a dominant position in enterprises (Park and Luo, 2001; Troilo and Zhang, 2012). As a visible hand that controls the lifeline of the state, the government plays a guiding role in the market to a considerable extent, as well as controlling the banking system (Chen *et al.,* 2011b; Qian, 2000). Due to the unsound and poorly implemented supervisory mechanism, individuals are provided with the opportunity to gain advantages by relying on the government and make power-for-money deals (also see Chapters 4 and 7), thus blocking the action of the market (Walder, 1986; Chang, 2011; Gao and Fennell, 2017; Fan, 2002). A market economy stresses equivalent exchange and advocates freedom, justice and competitive relationships, while a socialist market economy is characterised by governmental macro-control (Qian, 2000), and in case of improper macro-control, the market-oriented mechanism will be broken, thus generating latent social rules such as *guanxi*. Therefore, during this social transformation period, it is necessary for the

government to transfer from the "rule of people" to the "rule of law" and establish a lawful society to protect the rights of ordinary people and SMEs. The Chinese banking industry should also improve its lending policies and formal institutions to adapt to the demand of SMEs in the new age, and finally eliminate the dark side of latent rules such as *guanxi* in society.

However, the purpose of this thesis is not to provide specific solutions but to present the reality, in the hope that it could help to gain a greater understanding of the Chinese economy. Particularly for those readers who are interested in Chinese economic behaviours and problems, for example, researchers (particularly from the 'west') who want to understand and study SME lending problems in China, or overseas investors (i.e. external funding providers) who want to invest or participant in Chinese SME lending, or people who want to deal with Chinese people and to do business with them, this thesis could help them learn the Chinese SME lending pattern and thus understand the Chinese economy better. At the same time, like Granovetter who tries to balance over-socialisation and under-socialisation, this research also calls on future researchers to find a balanced point between the application of 'generalised morality', informal (i.e. culture and *guanxi*) and formal institutions in Chinese SME lending, and finally find ways to improve the financial regulation in China, particularly in the banking industry, as well as to solve problems such as social disorder and moral crises in this area.

Although this thesis talks about many differences between China and 'western' countries (i.e. ideology, research approaches like data collection method, way of thinking and expression and so on), the purpose is not to separate them but to combine these to some extent. Indeed, this thesis uses 'western' theories (the Embeddedness Theory, the Institution and Institution Change Theory) to analyse the Chinese concept of *guanxi*. At the same time, this thesis also uses the primary data and findings obtained from China to support and enhance some facets of these theories. This thesis uses a *guanxi* structure to measure the strength and efficacy of *guanxi* between financial institutions like banks and SMEs, and finally obtains the result that SME lending is embedded in *guanxi* in China, which means *guanxi* as a kind of informal institution, social tie and social capital

could affect Chinese SME lending culturally and institutionally. I believe China could learn many things from the west, and Chinese researchers could also use appropriate 'western' approaches to solve relevant Chinese problems. Moreover, we should also make some contributions to these theories by applying them practically from a Chinese perspective. Furthermore, I hope this thesis could be like a 'blasting fuse', and draw attention to those (especially overseas) researchers who are interested in and would like to participate in Chinese economic researches. In addition, the author of this study hopes that future researchers could use more 'western' methods to solve problems, particularly in the Chinese SME lending area.

Appendix

Table 1.1 Classification standards for Chinese SMEs

Industry	Indicator	Medium	Small	Micro
Agriculture Forestry Farming; Fisheries	Operating revenue (OR)	200-5	5-0.5	<0.5
Manufacturing	Employee number (EN)	1,000-300	300-20	<20
	OR	400-20	20-3	<3
Architecture	OR	800-60	60-3	<3
	Total assets (TA)	800-50	50-3	<3
Wholesale trade	EN	200-20	20-5	<5
	OR	400-50	50-10	<10
Retail industry	EN	300-50	50-10	<10
	OR	200-5	5-1	<1
Transportation industry	EN	1,000-300	300-20	<20
	OR	300-30	30-2	<2
Warehousing industry	EN	200-100	100-20	<20
	OR	300-10	10-1	<1
Postal industry	EN	1,000-300	300-20	<20
	OR	300-20	20-1	<1
Accommodation industry	EN	300-100	100-10	<10
	OR	100-20	20-1	<1
Restaurants and catering	EN	300-100	100-10	<10
	OR	100-20	20-1	<1
Information transmission	EN	2,000-100	100-10	<10
	OR	1,000-10	10-1	<1
Software and IT services	EN	300-100	100-10	<10
	OR	100-10	10-0.5	<0.5
Realestate development	OR	2,000-10	10-1	<1
	TA	100-50	50-20	<20
Property management	EN	1,000-300	300-100	<100
	OR	50-10	10-5	<5
Tenancy and business services	EN	300-100	100-10	<10
	TA	1,200-80	80-1	<1
Other unlisted industries	EN	300-100	100-10	<10

Source: 'Regulations on Small and Medium-sized Enterprises (SMEs) Classification Criteria', MIIT, NBS MC, NDRC, 2011, Regulation No.300

NOTE: OR: Operating revenue; EN: Employee number; TA: Total assets. The unit of employee number is per person, the unit of operating revenue and total assets is per million CNY.

Table 2.1 *Guanxi* strength examples

Guanxi strength	Phenomena	Key characteristics
Strong (high level)	Family *guanxi*: Parents and children; Brothers and sisters; Husbands and wives; Other relatives. Old (close, family-like) friends; acquaintances	Stable and permanent; based on obligation; high level of trust of each other.
Medium	Ordinary friends; Neighbors (known to each other); Colleagues or Classmates.	Vary between stable and unstable; social interaction; based on reciprocity.
Weak (low level)	Strangers: Seller and buyer; Taxi driver and passenger; Waiter and customer in a restaurant. New friends.	Unstable and temporary; generally first time meeting with each other.

Table 3.1. Brief description of interviews

No.	Interview code	Interviewee	Institution type	Place of interviews
1	Transcript 1a (T-1a)	Loan manager 1 (LM1)	Micro-credit Company (MCC-A)	City-D
2	T-1b (pilot interview)	LM1	MCC-A	City-D
3	T-2	LM2	Joint-stock commercial bank (JSCB-A)	City-A
4	T-3	LM3	City commercial bank (CCB-A)	City-D
5	T-4a	LM4	CCB-B	City-B
6	T-4b (pilot interview)	LM4	CCB-B	City-B
7	T-5	LM5	CCB-B	City-B
8	T-6	LM6	'Big-Five' state-owned commercial bank (SOCB-A)	City-D
9	T-7	LM7	CCB-C	City-C
10	T-8	LM8	JSCB-B	City-C
11	T-9	LM9	SOCB-B	City-D
12	T-10	SME manager 1 (EM1)	Subsidiary manufacturing SME (SME-1)	City-D
13	T-11	EM2	Manufacturing SME (SME-2)	City-D
14	T-11	EM3	SME-2	City-D
15	T-12	EM4	SME-3	City-C
16	T-13	EM5	SME-4	City-C
17	T-14	EM6	SME-5	City-C
18	T-15	EM7	SME-6	City-C
19	T-16	EM8	Group Company (Medium-sized enterprise-1)	City-C
20	T-17	EM9	SME-7	City-C
21	T-18	EM10	SME-8	City-D

Notes: (i) A, B, C and D represent different banks or cities. For example, CB-A means city commercial bank A, while CB-B means another city commercial bank B, but they are all belong to the type of city commercial bank.

(ii) City A is the largest city in this research, City B is the second largest, C is the third largest and D is the smallest.

(iii) EM2 and EM3 were from the same enterprise and they were interviewed at the same time, so they are in the same transcript

IG1. Pilot interview guide

1. I am interested in how modern banking and traditional Chinese customers co-exist nowadays, especially the *guanxi* between loan managers and SME managers. We will come to these in a while - but first I'd like to know a bit about you and this bank. So can you tell me something about your job? For example, how long have you been being the loan manager in the bank? What is your main job in the bank everyday? (Purpose: to obtain the background information of the loan manager. Despite the interviews, I may obtain information from other resources, i.e. general chat, having dinner together; I think I will also add these and take notes in the transcript report.)

2. How do you lend loans to enterprises in your daily work? You may take an example to explain the process of lending loans to enterprises in practice. Is this lending technology most frequently used in your bank and why? If not, can you briefly introduce the one that is mostly used in your work and explain why? (Purpose: the aim of this question is to find out what lending technologies are mostly used in practices in China. May be this question will not cover all the lending technologies used by the banks, so I think I will investigate the rests from other resources, such as their websites.)

3. What do you think are the advantages or disadvantages of these lending technologies used in practice? Could you give me some examples when they worked well? … Are there any situations that these lending technologies did not work well? If so, do you have any recommendations to improve it? (Purpose: mainly to find out the disadvantages of previous lending technologies and think about whether and how we can use *guanxi* to amend these problems.)

4. Great, you really helped me a lot in understanding these lending technologies. Since my research is about the role of *guanxi* plays in the lending process. So could you tell some examples of your latest lending business with enterprises? (Purpose: what I was thinking before is that in order to ask the following questions such as 5-8, I need specific examples. I think only through examples can I ask questions like "what is frequency of your meeting with the specific enterprise manager" and so on. So I ask them to provide some latest examples.)

5. Whom will you meet with when you are lending loans to SMEs? With enterprise manager or other relevant people? Will you meet with each other every month or several months? Or only when you have business? Would you please take an example? What will you mainly do in the meeting? Only talk about business or also includes other daily experiences such as family affairs? (In China, if people would like to share things such as family affairs with each other always mean they are very close, or have good *guanxi* with each other.)

6. Do you often have dinner together or have other social activities? What is the frequency? Are these kinds of social activities also happened regularly when you are

dealing with other enterprise managers? If not, why? (Chinese people treat these kind of social activities very important; many businesses are done on table during the dinner. These activities can also enhance the closeness between persons; Chinese people usually build high-level *guanxi* through these activities.) (Purpose: to find out whether the more often they meet with each other (or more social interactions with each other), the deeper the *guanxi* between them?)

7. Could you tell me how you build up a relationship with the manager of an enterprise? Is it the same with all managers? What is the relationship like? (Optional question: If you have a brotherhood feeling towards him or you are very good friends, is it also the reason why you would like to have dinner or attend other social activities with him?) Are you friends with all your clients or with just a few? (Purpose: the same as question 5. Besides, I think if they are good friends or they have brotherhood feelings towards each other can also means there exists a high level trustworthiness between them. These questions can also reflect the strength of *guanxi* between them. If they are just normal friends or business partners, I think the *guanxi* between them is medium level. While if they have brotherhood feelings towards each other, then the *guanxi* between them is high level.)

8. Apart from the lending technologies, will you also consider/judge/inspect the SME manager's personal credit before lending? If so, how will you measure it? We all know that Western countries like UK have a perfect system for credit lending. Chinese banks will also need to develop these kinds of lending technologies in the future (credit lending is developing in China but it is rarely used in practice, I think one reason is because of lacking credit score system). So what do you think are important in order to improve this situation? Do you have any recommendations? Do you think build and maintain a good *guanxi* with SME managers is a proper way? (Purpose: this is the entry point to introduce bank-SME *guanxi* here, because I do not think it is a good idea to introduce *guanxi* directly, so I need to say something else first.)

9. What elements do you think are important to maintain your *guanxi* with SME managers? Or how will you maintain it? And how these elements will affect your *guanxi*? (I do not think it is a good question to ask them directly how they define *guanxi*. Because *guanxi* is a complex concept and deeply embedded in Chinese people. They may not be able to answer what is the definition of *guanxi*. It is just like what if I ask "what is the definition of the relationship between you and me?" How will you define it? I think it is better to ask what elements are important in your *guanxi* with SMEs and these elements define *guanxi*.)

IG2. Loan manager formal interview guide

Part 1. General questions

1. Please briefly introduce your bank/company and your job. Who are your main customers? Their firm sizes, especially the small and medium enterprises?

2. How long have you been being the loan manager in the bank?

3. What is your main job in the bank/company every day?

4. How do you lend loans to enterprises in your daily work? What is the lending procedure in detail? For example, is there any requirements or detailed methods?

5. Which lending method is mostly used in your work? What do you think are the advantages or disadvantages of these lending methods used in practice? Are there any situations that these lending technologies did not work well? Can you take some examples?

6. Do you have any recommendations to improve these lending methods?

7. How long is the longest firm that borrow loan from you? Is it easier to get loan from you if you and the firm have cooperated with each other for a longer time? Can you take some examples?

8. Could you tell me how you build up a relationship with the enterprise usually? Will they come to you or your customer managers will chase for them?

9. Whom will you meet with when you are lending loans to SMEs? With enterprise manager or also other relevant people? What is frequency of your meeting with the enterprise manager? Every month or several months? Or only when you have business with each other? Could you take an example?

10. What will you mainly do in the meeting, only talk about business or also includes other daily experiences such as family affairs?

Part 2. Specific questions

'Soft' information topic questions:
About *ganqing*:

11. What is your *guanxi* like with your clients? Like friends or only for business?

12. Are you preferred to do business with acquaintances rather than strangers? Why?

13. If you have two applicants, one is acquaintance and the other is not that familiar, then will you consider the acquaintance in priority? For example, lend him the loan first or lend him more loans?

14. Will you still contact with each other after the repayment?

About giving gifts:

Ask loan managers (especially the loan managers from state-owned banks):
15. To us Chinese, *renqing* is unavoidable, so what do you think of giving gifts? Is it a common phenomenon in the whole industry? Do you think it will affect the final lending decision? If yes, how much will it affect?

'Common friends' *guanxi* **topic questions:**

16. Will you ask your common friends about your customer's (borrower) condition? Some information that the borrower would not tell you directly, for example, whether the enterprise is functioning normally (but not near bankruptcy) or the borrower has bad hobby such as gambling and so on.

17. If yes, then how do you ask your common friends about the borrower's condition? What questions will you ask? And how you deal with these information and how you operate it in detail? For example, how these (soft) information will affect the final lending decision (to what extent, what percentage)? Then how do you know whether they (the common friends) are telling the truth or not? What if they did not tell the truth and only say good words for that customer since they know each other well? How to test these common friends' integrity?

18. Will you have lunch or dinner with SME managers? If yes, what will you talk about during that time? Only about business or also include other things?

19. Will you ask something information about other borrowers? For example, another SME manager you both know but who did not present in the lunch, and this guy also wants to borrow loan from you. If yes, what will you ask? Will these information affect your lending decision? If yes, how will you deal with it? How will you record, store and quantify it as a factor that affect the lending decision?

Non-financial analysis topic questions:

20. Is there any non-financial analysis of SMEs in your bank or company? How many non-financial factors are there? Can you take some examples?

21. How will you measure/evaluate these non-financial factors? And how these non-financial factors will affect the lending decision?

22. How do you record, store and track these non-financial information if there are

dozens of it? For example, write a report to record them? How will these information affect the final lending decision? Is this an indicator in the final lending decision? If it is, then how will you measure it? How much weight will it affect the final lending decision? Is there any measurement standard? How will you justify and quantify these information and make them accountable to your boss? And finally how do you make the lending decision based on these information? Can you take some examples?

23. Take a simple example, if the non-financial information you get is bad, which means when you talk to the workers, they said that they have not got their wages for a long time and the enterprise is not able to sell the products. But the financial information (such as balance sheet) provided by the SME manager is good. Then will you still lend the loan? How will you balance these two situations? Is there any standard for the balancing? For example, financial data is more important and these information are less important? What percentage?

Part 3. Open questions

24. Are there any other suggestions for the improvement of SME and bank *guanxi*? For example, improving the lending process? Solving the financial constraint problem for Chinese SMEs?

IG3. SME manager formal interview guide

Part 1. General questions

1. Please briefly introduce your enterprise? Firm size? Firm age? Main product? Annual turnover?

2. How do you get loans? Where do you mainly get loan from? Relatives? Banks or other financial institutions? About what percentage?

3. Do you have difficulties in getting loan from banks? Why?

4. What are the three main banks that you cooperate most?

5. How long is the longest bank that lend loan to you? Is it easier to get loan from the bank that you have cooperated with each other for a longer time? Or you are more familiar with the loan managers? Can you take some examples?

6. How do you build up a relationship with the bank usually? Will they come to you or your will chase for them?

7. What is frequency of your meeting with the loan manager? Every month or several months? Or only when you have business with each other? Could you take an example?

8. What will you mainly do in the meeting, only talk about business or also includes other daily experiences such as family affairs?

Part 2. Specific questions

'Soft' information topic questions:

About *renqing*:
9. Are there any situations that if the loan amount is very large, you would rather borrow the money from micro-credit companies than your relatives or friends, because you does not want to own *renqing* to them? If yes, how large is the loan amount would make you rather not to borrow from their relatives, but from the micro-credit company and pay the transaction fee? How much you can afford for the transaction fee in order not to own *renqing*?

About giving gifts:
10. To us Chinese, *renqing* is unavoidable, so what do you think of giving gifts? Is this phenomenon common? Do you think it is helpful in getting the loan? If yes, how

large is the help? Is it a determinant factor?

About *ganqing*:
11. In your experience interacting with banks, is it easier to get loan from a more acquainted loan manager? For example, there are two loan managers from two banks; one is more familiar with you but the other is not that familiar, is it easier to get loan from the one who is more familiar with you? If not, is it only because of they are different banks? Some banks are easier to lend loan while others are not? Or are there any other reasons?

12. What do you think of your *guanxi* with loan managers? Are they your friends or just for business?

13. Will you still contact with each other even after the repayment?

'Common friends' *guanxi* topic questions:
14. Will you have lunch or dinner with SME managers? If yes, what will you talk about during that time? Only about business or also include other things?

15. Will the loan manager ask something information about other borrowers? For example, another SME manager you both know but who did not present in the lunch, and this guy also wants to borrow loan from the loan manager. If yes, what will they ask? Can you take some examples?

Part 3. Open questions

16. Do you have any suggestions for improving the lending process? If you have difficulties in getting loan from banks, do you have any suggestions for improving this situation? What help do you need in getting the loans?

IG4. Re-interview guide

1. 'Soft' information topic questions:

Ask interviewee 1,2:
1. You mentioned before 'walk around the enterprise and talk to the workers' is a good way to get some information, but how do you deal with these information? How do you record, store and track these information if there are dozens of it For example, write a report to record them?

2. How will these information affect the final lending decision? Is this an indicator in the final lending decision? If it is, then how will you measure it? How much weight will it affect the final lending decision? Is there any measurement standard? How will you justify and quantify these information and make them accountable to your boss? And finally how do you make the lending decision based on these information? Can you take some examples?

3. Take a simple example, if the information you get is bad, which means when you talk to the workers, they said that they have not got their wages for a long time and the enterprise is not able to sell the products. But the financial data provided by the SME manager is good. Then will you still lend the loan? How will you balance these two situations? Is there any standard for the balancing? For example, financial data is more important and these information are less inportant? What percentage?

Ask the interviewee 1:
4. About on-lending, I am not quite understand it. What if the bank does not want to re-lend the loans? What will happen? Can you explain more about it? Are there any examples?

About *ganqing*:

Ask interviewee 2:
5. You mentioned before that the reason why you want to maintain *ganqing* with your customers is in order to control the risk. Then why you can control risk by maintaining *ganqing* with them? Is it because of that you can obtain more relevant information? How will you deal with these information and consider it as a method to control risk? How will you quantify these information?

2. 'Common friends' *guanxi* topic questions:

Ask interviewee 2:
6. You have said before that you will get your customer's information from other tenants in the same market, then how do you ask other tenants about the borrower's condition? For example, what questions will you ask? And how you deal with these information , how you operate in detail? For example, how these (soft) information will affect the final lending decision, to what extent, what percentage?

7. You have also mentioned before that you still lend loan to the customer who was used to be addicted in gambling and lost everything, because you heard from other tenants that he did give up gambling, then how do you know whether they (other tenants) are telling the truth or not? What if they did not tell the truth and only say good words for that customer since they know each other well? How to test these common friends' integrity?

Ask interviewee 1:
8. You said that sometimes you will have lunch with several SME managers together, so what will you talk about during that time? Only about business or also include other things?

9. Will you ask something information about other borrowers? For example, another SME manager you both know but who did not present in the lunch, and this guy also wants to borrow loan from you. If yes, what will you ask? Will these information affect your lending decision? If yes, how will you deal with it? How will you record, store and quantify it as a factor that affect the lending decision?

3. Non-financial analysis topic questions:

Ask interview 2:
9. You said that there are financial analysis and non-financial analysis in banks before, so could you tell me what is non-financial analysis in detail?

10. How will you measure/evaluate the non-financial factors? For example, what is borrowing power exactly? How will you evaluate the borrower's borrowing power and how is it applied in the lending process in detail. How will you quantify it and use it as an indicator to affect the final lending decision?

11. About the borrowing power example you said before, how will they evaluate the borrower's relatives' repayment ability? How do you bank know that if he makes a phone call and his relative will send money, what if they do not? Why should the bank trust that if the borrower makes a phone and his relatives will send the money? How do you control this risk? Are there any methods? Are there any methods to control this risk?

12. Apart from the borrowing power, are there any other non-financial factors? How do you measure them? Can you take some examples?

Ask interviewee 1:
13. Is there any non-financial analysis of SMEs in your company? Can you take some examples of non-financial factors that will affect the lending decision?

14. How many kinds of non-financial factors are there and what are they? How will you measure/evaluate these non-financial factors?

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