

Impact of SMEs Character in The Loan Approval Stage

Yeo Tze Sheng

Economic and Finance Department
School of Business, Curtin University
Miri, Malaysia
e-mail: tzesheng.yeo@curtin.edu.my

Nazatul Shima Abdul Rani

Marketing and Management Department
School of Business, Curtin University
Miri, Malaysia
e-mail: shimarani@curtin.edu.my

Junaid M. Shaikh

Accounting & BIS Department
School of Business, Curtin University
Miri, Malaysia
e-mail: junaid.s@curtin.edu.my

Abstract—We attempt to integrate the prior literature on SME financing, and propose that these issues should be researched in a structured and holistic manner. To that end, we suggest that SME financing can be studied from the supply side (banks') perspective, but not be restricted to a discussion on the quantum of loan, or other quantitative measures alone. We put forward 5 categories of items that we believe should be discussed in any work concerning SME financing, being (a) the SME's personality, (b) the viability of the SME's business and/or its industry, (c) the SME's knowledge and competency, (d) the financial position of the SME, and (e) the level of detail and preparation of the loan application. We further attempt to provide examples of items to be discussed in each category based on works from the literature

Keywords—character of SME, loan application, success, bank

I. INTRODUCTION

According to the Malaysian central bank's report, loans outstanding to Small and Medium Enterprises (SMEs) by the banking industry in the country was worth RM 104.6 billion in 2006 [3]. This amount, representing 44.5% of the total loans outstanding at that time, not only highlights the strong contribution of the SME sector to loan demand for the banking industry, but also a heavy reliance of the SME sector on the banking sector for financing purposes.

As SMEs have been acknowledged to play an important role in the growth of an economy, especially in developing countries such as Malaysia ([36]; [5]), understanding SMEs and their characteristics has its appeal. This study chooses to concentrate on the perspective of the banks regarding issues faced by SMEs when applying for loans from local commercial banks. Our paper is motivated by the fact that obtaining external financing often represents a significant, yet important, challenge faced by SMEs, especially ones which are growing, as noted by [40], (cited in [26]).

II. LITERATURE REVIEW

Several studies have found that SMEs rely on financing from banks as an important source of finance. For instance, [9] discuss the issue in a Swedish context, where firms showed a tendency to shift to using external funding from banks once internally generated funds were insufficient for their needs. Furthermore, drawing on the ideas of the pecking order theory, [25] and [33] respectively survey that English and Spanish SMEs rely heavily on debt financing once cash flow from internal resources is exhausted.

On the other hand, from a bank's perspective, financing to SMEs is often regarded to be of higher risk due to the relative opaqueness of these firms as compared to larger firms [6]. As such, banks tend to scrutinise different aspects of an SME when making the lending decision, with the first step in the loan approval often involving the banks attempting to "seek signals from borrowers" [38], cited in [15]. [28] also test the hypothesis from [6] in countries severely affected by the Asian financial crisis in 1997/98, finding that banks in Indonesia are less reliant on relationship lending as compared to their Korean and Filipino peers.

Further, [21] summarise a stream of literature that discuss the role of relationship lending in the loan application process. This is especially true when banks deal with SMEs which are relatively more opaque compared to their larger peers. [14] note that due to this relative opaqueness, small firms may find that small banks, which are able to establish closer relationships between lender and borrower, are more willing to extend credit to them. However, this relationship is unclear as some studies have found that such a relationship is not established in empirical data ([7]), who set their study in a period after the banking sector was driven to consolidate. With her banking sector undergoing a unique round of consolidation in the early 2000s as described by [13], we believe a study in Malaysia can contribute to the understanding of the role of banks in SME financing.

We further note that, perhaps due to the emphasis on capital adequacy rules for risk management under Basel II,

there is an increased tendency in some parts of the literature to move away from analyzing SME loans on subjective personal relationships, and replacing it with credit models for assessing the credit risk exposures of banks to SMEs. Such models have been discussed and developed in [19], who note that SME portfolios are unique as compared to large corporate loans. They also contend that the sheer number of individual SMEs in a loan portfolio of a bank complicates the modelling of SME credit risks at an individual level by merely looking at the quantum of loans approved.

We believe this provides room to study SME loans from other dimensions besides the size of the loans being sought by the SME. This view is shared by [2] who point out that qualitative characteristics may have predictive power for the success of bank loans. In our framework, we try to better understand these dimensions of the relationship between the SME and the lending bank, by examining the bank manager's perception of different aspects of an SME in the loan application process. In that regard, a piece of work by [24] is particularly relevant to the Malaysian context. They detail the loan application process, and identify several issues that are believed to affect the bank manager's probability in approving a loan application. Using their work as a guide, the theoretical framework below is put forward.

III. THEORETICAL FRAMEWORK

We build on the work of [24] by classifying the issues they suggested into five different categories, and attempt to examine the issue from a fresh angle. Specifically, we believe that the issues above relate to (i) the personality of the loan applicant from the SME as perceived from the bank officer's perspective; (ii) the viability of the business and the industry in which the SME operates in; (iii) the knowledge of the SME or the loan applicant with regards to skills required in operating a business; (iv) the financial position of the SME when applying for the loan; (v) the level of preparation in planning the details of the loan, and we propose to test whether these factors impact on the chances of a loan being approved by a bank's lending officer.

A. Personality of SME

[27] summarise a host of literature that have long examined a bank's loan approval relationship with SMEs. For instance, they cite [18] who study the risk assessment procedures used by banks to evaluate SMEs, and [8] who studied the impact of information asymmetry in the bank-SME relationship. They also note more recent studies have analysed SME characteristics along the lines of gender and ethnicity ([10]; [4]; [22]; [12]), or along the lines of a social capital theory which contends that social networks (or a lack thereof) have an impact on the chances of an SME being granted loans from a bank ([11]).

We, however, believe that analysing SMEs personalities along the lines of gender or ethnicity is too general in scope. Instead, we suggest that there is room for the literature to discuss the issue in a less restrictive manner. To that end, we

attempt to draw from [24] who have identified specific items that could potentially better pinpoint factors involved in the loan application relationship. We propose researchers studying the issue can focus on other items, such as by setting questionnaires to probe (a) the persistence of the loan applicant, (b) the first impression projected by the loan applicant, (c) applicants who do not listen to the opinion of others, (d) applicants who have ulterior motives in running the business, (e) applicants who run a business as a 'one-man' show, and (f) the confidence of the loan applicant. By doing so, we believe that the subconscious process undergone by a loan officer can be better understood when determining whether to grant a loan.

TABLE 1: RECENT WORKS RELATED TO THE CHARACTERS OF SME LOAN APPLICANTS

Authors	Year	Focus
Basu	2004	Ethnicity
Fraser	2005	Gender
Carter & Shaw	2006	Social networks
Carter, Shaw,	2007	Gender
Lam & Wilson		
Scott & Irwin	2010	Gender & Ethnicity

B. Viability of SME

Aside from the higher perceived risks arising from information asymmetry problems inherent in dealing with SMEs in general, SMEs can also be viewed to have higher risks due to the various challenges inherent in their operations and in the markets in which they exist ([16], cited in [23]). [23], who surveyed businesses in Australia, also noted the differing success factors of SMEs across varying industries. Furthermore, [34] and [30] detail the various criteria necessary for a manufacturing SME to be viable. From the quality of the products or services offered by the SME to the way the business model is set up, SMEs face higher risks of failure if not run efficiently. For the bank providing loans to SMEs, these risks of failure may affect the loan approval decision and we suggest to examine their impact by studying the following items, (a) the competitiveness of the industry in which the SME operates in, (b) the profitability of the SME's operations, and (c) the maturity stage of the SME in its industry.

TABLE 2: RECENT WORKS RELATED TO THE VIABILITY OF SMES

Authors	Year	Focus
Gadenne	1998	Various criteria across retail, service and manufacturing industries
Mohd Yusof & Aspinwall	2000	Total quality management in small medium enterprises
Kim, Knotts & Jones	2008	Management practices and business model in manufacturing sector

C. Knowledge of SME

The extent of professional skills possessed by staff in an SME, in relation to the knowledge required in running a

business efficiently, is another category of items we propose can be examined. The skill sets of the owners and staff of an SME have been found to play an important role in determining the success of an SME [35], whereas a lack of such skills might increase the risks of an SME failing, and hence reduce the likelihood of obtaining loan approval from banks. [37] further point out that managerial competence in the small business context may have implications on the entrepreneurial style, and subsequently on the success of an SME. Even as an SME has gone international, business competence and knowledge in the field can still be important determinants in the success of an SME [31]. Thus, we believe that bank officers give due consideration to these issues when scrutinizing loan applications for bad applicants, and by studying such characteristics, further light can be shed on the extent to which a loan granted to such an applicant will be a successful or failed venture. As such, by examining items such (a) knowledge in accounting, (b) knowledge in marketing, (c) knowledge in management, (d) knowledge in managing working capital, (e) the knowledge of the SMEs about the banking facilities available, it is in our opinion that the relationship between SME knowledge or competence can be better related to the success of a loan application.

Table 3: Recent works related to THE knowledge of SMEs

Authors	Year	Focus
Sadler-Smith, Hampson, Chaston & Badger	2003	Relationship between managerial competence, entrepreneurial style, and firm type
Pérez de Lama & Duréndez	2007	Family-owned SMEs and competence in strategic management
Knight & Kim	2009	SME competence in an international context

D. Financial Position of SME

Having noted the qualitative aspects of an SME, we suggest that researchers studying SMEs and their successes should also account for the quantitative aspects of an SME, particularly on the financial position of the SME or its owner. To that end, we propose that items such as (a) the SME owner's equity contribution in the loan arrangement, (b) the availability of collateral, (c) whether the SME maintains other accounts with the lending bank, (d) the availability of an alternative source of income, should be noted by researchers. Indeed, firms better capitalised with capital received from equityholders are better received by bank lenders as the perceived riskiness is lower when the company balances debt and equity ratios properly [17]. [2] also note that historical accounting data has been used to predict bankruptcy after [1] revolutionary article on the z-score model. [32] is a recent example where he attempts to document the use of financial information to build a data systems model which is able to predict bankruptcy of SMEs. Additionally, [20] lists weak financial statements as the one

of the first challenges for banks when lending to SMEs. This would be relatively self-explanatory, as SMEs with poor financial health would more likely be shunned by lenders compared to SMEs with stronger balance sheets.

TABLE 4: RECENT WORKS RELATED TO THE FINANCIAL POSITION OF SMEs

Authors	Year	Focus
Cressy & Olofsson	1996	SME capitalization and firm riskiness
Dutta	2005	Indian firms' reliance on financial information
Laitinen	2008	Data system based on financial information to predict SME failure

E. Level of Preparation of SME

Finally, [39] argue that of relative importance to the success of an SME being able to seek external financing has to do with its attention to detail in preparing a business plan and loan proposal when applying for the loan. Additionally, it was observed that an inability to determine information disclosures by the SME, can be regarded as signs that the management is weak or lacks financial discipline ([29], cited in [39], p. 84). As such, we believe that researchers can pay attention to this area, and we propose to test for this aspect by examining the following items (a) the urgency of the loan approval, (b) dependence on the loan officer to determine loan amounts and other terms in the loan application, (c) the professionalism of the SME in applying for the loan, (d) the sureness of the loan amount being sought, (e) the clarity of the business direction, (f) a clear business plan, and (g) the amount of information provided by the SME in the loan application.

TABLE 5: RECENT WORKS RELATED TO THE PREPARATION OF SMEs

Authors	Year	Focus
Hossain	1998	Bangladeshi SMEs challenges in seeking finance
Wattanaputtipaisan	2003	ASEAN SMEs challenges in seeking finance

The items discussed above are summarised in the following conceptual diagram (Fig. 1),

IV. CONCLUSION

We put forward the idea of studying SME financing issues from the supply side (banks') perspective, but with a more holistic approach where several qualitative categories of a loan application is considered. We based our research on Haron and Shanmugam (1994)'s paper, and attempt to provide a more structured approach to the research by means of classifying the items in distinct, although possibly overlapping, categories. We find that prior literature do

discuss some of the items, and we propose to integrate these into a conceptual framework that can provide a more comprehensive picture of issues considered by a bank officer when considering loan applications from SMEs. Works on such issues can not only help the SME better understand areas of improvement in seeking for bank financing, research in this area can also allow the banking industry to better understand the role of qualitative information in the loan application process, and should allow for more competitive risk management practices as is appropriate in the current regulatory regime for the banking industry.

REFERENCES

- [1] Altman, E. (1968) 'Financial ratios, discriminant analysis and the prediction of corporate bankruptcy', *Journal of Finance*, Vol. 23, No. 4, pp. 589-609.
- [2] Altman, E., Sabato, G. and Wilson, N. (2008) *The value of qualitative information in SME risk management*, <http://www.efmaefm.org/0EFMAMEETINGS/EFMA%20ANNUAL%20MEETINGS/2009-milan/363.pdf>
- [3] Bank Negara Malaysia (2006) *Small and medium enterprise (SME) annual report 2005: Access to financing*, http://www.bnm.gov.my/files/publication/sme/en/2006/chap_7.pdf
- [4] Basu, A. (2004) 'Entrepreneurial aspirations among family business owners: An analysis of ethnic business owners in the UK', *International Journal of Entrepreneurial Behaviour & Research*, Vol. 10, Nos. 1-2, pp.12-33.
- [5] Beck, T., Demirguc-Kunt, A. and Levine, R. (2005) 'SMEs, growth, and poverty: Cross-country evidence', *Journal of Economic Growth*, Vol. 10, No. 3, pp. 199-229.
- [6] Berger, A. and Udell, G. (2006) 'A more complete conceptual framework for SME finance', *Journal of Banking & Finance*, Vol. 30, No. 11, pp. 2945-2966.
- [7] Berger, A., Rosen, R. and Udell, G. (2007) 'Does market size structure affect competition? The case of small business lending,' *Journal of Banking & Finance*, Vol. 31, No. 1, pp. 11-33.
- [8] Binks, M., C. Ennew, G. Tand Reed (1992). Information asymmetries and the provision of finance to small firms. *International Journal of Small Business*, Vol. 11, No. 1, pp. 35-46.
- [9] Bruns, V., Fletcher, M. (2008) 'Banks' risk assessment of Swedish SMEs', *Venture Capital*, Vol. 10, No. 2, pp. 171-194.
- [10] Carter, S. and Rosa, P. (1998) 'The financing of male- and female-owned businesses', *Entrepreneurship & Regional Development*, Vol. 10, No. 3, pp. 225-241.
- [11] Carter, S. and Shaw, E. (2006) *Women's business ownership: Recent research and policy developments*, Research report to the Small Business Service: London.
- [12] Carter, S., Shaw, E., Lam, W. and Wilson, F. (2007) 'Entrepreneurship, and bank lending: The criteria and processes used by bank loan officers in assessing applications', *Entrepreneurship Theory and Practice*, Vol. 31, No. 3, pp. 427-444.
- [13] Chong, B., Liu, M. and Tan, K. (2006) 'The wealth effect of forced bank mergers and cronyism', *Journal of Banking & Finance*, Vol. 30, No. 11, pp. 3215-3233.
- [14] Cole, R., Goldberg, L. and White, L. (2004) 'Cookie cutter vs. character: The micro structure of small business lending by large and small banks', *Journal of Financial & Quantitative Analysis*, Vol. 39, No. 2, pp. 227-251.
- [15] Cowling, M. and Westhead, P. (1996), 'Bank lending decision and small firms: Does size matter?', *International Journal of Entrepreneurial Behaviour and Research*, Vol. 2, No. 2, pp. 52-68.
- [16] Cragg, P. and King, M. (1988) 'Organisational characteristics and small firms' performance revisited', *Enterprise Theory and Practice*, Vol. 18, Winter issue, pp. 49-64.
- [17] Cressy, R. and Oloffson, C. (1996) 'The financial conditions for Swedish SMEs: Survey and research agenda', *Small Business Economics*, Vol. 9, No. 2, pp. 179-192.
- [18] Deakins, D. and Hussain, J. (1991) 'Risk assessment by bank managers', Working paper. University of Central England: Birmingham.
- [19] Dietsch, M. and Petey, J. (2002) 'The credit risk in SME loans portfolios: Modeling issues, pricing and capital requirements', *Journal of Banking & Finance*, Vol. 26, No. 2-3, pp. 303-322.
- [20] Dutta, P. (2005) *SME sector strategies for increasing credit flow*, MBA thesis, Faculty of Management Studies: Delhi.
- [21] Elyasiani, E. and Goldberg, L. (2004) 'Relationship lending: A survey of the literature', *Journal of Economics and Business*, Vol. 56, No. 4, pp. 315-330.
- [22] Fraser, S. (2005) *Finance for small and medium sized enterprises: A report on the 2004 UK survey of SME finances*, Warwick Business School: Coventry.
- [23] Gadenne, D. (1998) 'Critical success factors for small businesses: An inter-industry comparison', *International Small Business Journal*, Vol. 17, No. 1, pp. 36-56.
- [24] Haron, S. and Shanmugam, B. (1994) 'Lending to small business in Malaysia', *Journal of Small Business Management*, Vol. 16, No. 3, pp. 245-259.
- [25] Hughes, A. (1997) 'Finance for SMEs: A U.K. perspective', *Small Business Economics*, Vol. 9, No. 2, pp. 151-166.
- [26] Hussain, J., Millman, C. and Matlay, H. (2006) 'SME financing in the UK and in China: A comparative perspective', *Journal of Small Business and Enterprise Development*, Vol. 13, No. 4, pp. 584-599.
- [27] Irwin, D. and Scott, J. (2010) 'Barriers faced by SMEs in raising bank finance', *International Journal of Entrepreneurial Behaviour & Research*, Vol. 16, No. 3, pp. 245-259.
- [28] Jiangli, W., Unal, H. and Yom, C. (2008) 'Relationship lending, accounting disclosure, and credit availability during the Asian financial crisis', *Journal of Money, Credit and Banking*, Vol. 40, No. 1, pp. 25-55.
- [29] Kao, R. and Tan, W. (2001) *Entrepreneurship and Enterprise Development in Asia*, Prentice Hall: Singapore.
- [30] Kim, K., Knott, T. and Jones, S. (2008) 'Characterising viability of small manufacturing enterprises', *Expert Systems with Applications*, Vol. 34, No. 1, pp. 128-134.
- [31] Knight, G. and Kim, D. (2009) 'International business competence and the contemporary firm', *Journal of International Business Studies*, Vol. 40, No. 2, pp. 255-273.
- [32] Laitinen, E. (2008) 'Data systems for assessing probability of failure in SME reorganization', *Industrial Management & Data Systems*, Vol. 108, No. 7, pp. 849-866.
- [33] Lopez-Garcia, J. and Sogorb-Mira, F. (2008) 'Testing trade-off and pecking order theories financing SMEs', *Small Business Economics*, Vol. 31, No. 2, pp. 117-136.
- [34] Mohd. Yusof, S. and Aspinwall, E. (2000) 'Critical success factors in small and medium enterprises: survey results', *Total Quality Management*, Vol. 11, No. 4/5&6, pp. 448-462.
- [35] Pérez de Lama, D. and Duréndez, A. (2007) 'Managerial behavior of small and medium-sized family business: An empirical study', *International Journal of Entrepreneurial Behaviour & Research*, Vol. 13, No. 3, pp. 151-172.

[36] Rasiyah, R. (2002) 'Government-business coordination and small business performance in the machine tools sector in Malaysia', *Small Business Economics*, Vol. 18, Nos. 1-3, pp. 177-194.

[37] Sadler-Smith, E., Hampson, Y., Chaston, I. and Badger B. (2003) 'Managerial behavior, entrepreneurial style, and small firm performance', *Journal of Small Business Management*, Vol. 41, No. 1, pp. 47-67.

[38] Storey, D. (1994) *Understanding the small business sector*, Routledge: London.

[39] Wattanapruttipaisan, T. (2003) 'Four proposals for improved financing of SME development in ASEAN', *Asian Development Review*, Vol. 20, No. 2, pp. 66-104.

[40] Westhead, P., M. Wright (2000) 'Introduction', in Westhead, P., and Wright M. (eds.) *Advances in Entrepreneurship*, Vol. 1, Edward Elgar Publishing, Cheltenham, pp. i-xcvi.

FIG I. CONCEPTUAL FRAMEWORK FOR THE STUDY OF SME LOAN FINANCING ISSUES

