AN EMPIRICAL INVESTIGATION OF THE LENDING DECISIONS ON SMALL BUSINESSES BY BANK MANAGERS IN MALAYSIA

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ABSTRACT

The issue of 'finance gap' in the small business sector has long been a focus of discussion among academics and practitioners in the industrialised countries. Despite a number of attempts to close this 'gap' the problem persists, especially in relation to bank finance.. Studies have shown that the environment under which the banks operate is one of the factors that contribute to this 'gap'. These banks make lending decisions under conditions of uncertainty and asymmetry of information. As a consequence, the approaches taken by bankers when dealing with small business customers are biased. While the findings of these studies have contributed significantly to the existing literature, there is however a dearth of similar studies in the developing countries. Evidence suggests that the problem of 'finance gap' exists too in these countries. Furthermore, since the contribution of the small business sector has been well acknowledged, the difficulties in obtaining bank finance may provide a serious constraint to its growth. And any impediment to the growth of small businesses will have a profound effect on the economy.

The purpose of this study is therefore to contribute to an increased understanding of banks' lending decisions on small businesses. The study investigates how bank managers in Malaysia make lending decisions on small business propositions, and identifies the relative importance of criteria used in the loan evaluation. The study also aims to unearth a number of issues relating to the attitude and perceptions of bank managers towards small business customers. In order to achieve the foregoing objectives, a qualitative interview technique was employed. It has been suggested that to understand fully a bank manager's decision-making process, an in-depth investigation is needed. Therefore, the methodology employed in this study is to observe the process in a realistic or close to an actual situation as possible.

The findings reveal that a majority of bank managers under study were extremely cautious when dealing with small businesses. However, there was no uniformity and consistency among them when making decision on whether to accept or reject the small business proposition. Because of an asymmetry of information and a perceived risk when dealing with small business customers, most of the bank managers adopted a 'collateral based' and 'gone concern' approaches in assessing the proposition. A number of attributes were also uncovered. Those who had been in the banking industry for a relatively longer period tend to be more conservative, and were less willing to support the business proposition. Graduate bank managers tend to employ a more quantitative approach in their lending assessment than their non-graduate counterparts, while managers of smaller banks were found to have a relatively higher rate approval on the proposition than managers of larger banks.

When ranking the criteria used in assessing the small business proposition, the bank managers were more preoccupied with risks, and they gave more weighting to the established businesses than new ones. However, the availability of collateral and government guarantee do not seemed to have a major impact as far as the lending decision is concerned. The findings also reveal some elements of biases in the decision because of indifferent attitudes and lack of understanding of small business customers among the bank managers. This is further compounded with the employment of a largely intuitive assessment on the small business proposition, and the non-availability of any formalised quantitative models to help in the decision.

The study concludes by recommending a number of approaches and strategies that need to be adopted by bankers, small business owners and policy makers to help in alleviating problems of the non-availability of finance to the small business sector. To increase the credibility of this study, further research on similar and related issues is also suggested.

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CHAPTER ONE

1. INTRODUCTION: COMMERCIAL BANKS AND SMALL BUSINESSES

1.1 BACKGROUND

Commercial banks and the small business sector are generally considered to play very important roles in the economic development of a nation. Commercial banks perform several activities deemed necessary for the functioning of the economic system. One function is that they act as financial intermediaries in transferring resources from surplus units to deficit units in the economy through deposit acceptance and lending activities, thus filling the diverse needs of ultimate lenders and borrowers. Dorfman (1991) summarises this function:

"The core of the banking business is the allocation of funds from people who have more funds on hand than they need at the moment and lending money to people who have more need for funds than they have funds available. When that function is performed well, productive activity and sensible consumption in the community are both encouraged".

The intermediary function of commercial banks constitutes an extremely important element of a financial system, because lenders and borrowers do not simply bypass intermediaries and come together directly. Heffernan (1996) cites two main reasons for the difficulty in bringing lenders and borrowers together. First, the presence of information costs undermines the ability of a potential lender to find the most appropriate borrower in the absence of intermediation. Secondly, the differences between financial requirements of lenders and those of borrowers are so great that the direct transfer of funds is effectively precluded. Being an intermediary, a commercial bank can offer expected returns to the lender (depositor) at relatively lower risks and costs. And by pooling a large number of borrowers and savers, a bank can also provide the necessary liquidity to meet the demand for funds because of unexpected events. The financial intermediary function of a commercial bank, therefore, provides the mechanism in which the needs of both the lender and borrower can be met (Molyneux, 1990).

Invariably, the profit motive lies behind the commercial bank's financial intermediary activity. It pays interest on the deposits and receives interest on the loan provisions (Pierce, 1991). As a business concern, it has to earn satisfactory returns on its undertakings. This is achieved through services rendered in spreading the risk of its smaller depositors and lending longer than it borrows (Fisher, 1971). But these activities are always subject to the constraints of liquidity, safety and social responsibility. To earn more profits, the commercial banks may provide longer-term loans, extend credit to borrowers with marginal creditworthiness, thus reducing idle cash balances. However, these actions can greatly reduce liquidity, which is needed to meet deposit withdrawals and credit demands (Reed et al, 1984; Sinkey, 1998). Furthermore, the commercial banks are required to channel a portion of the loan portfolio to certain priority sectors designated by the authorities, which may not necessarily provide them with higher returns. These authorities are interested to ensure that all sectors of the economy benefit from the activities of the banks. In addition, the authorities want to ensure that the public funds deposited in the banks are safe, and thus they require the commercial banks to manage them within the required legal and regulatory frameworks.

Notwithstanding, lending remains the cornerstone of banks' economic function. It is not only critical to the bank's profitability, but also vital for its survival. It is reported that earnings from the lending activities account for 80 per cent or more of the bank's profits (Wong, 1997). But lending is also the most risky function. The risks are numerous and varied, and stem from the circumstances which often result from non-payment of obligation when they become due. Thus, lending activity must be done efficiently and with a minimum of costs.

The foregoing discussion clearly underlines the benefits to be gained from the activities of commercial banks. It is generally agreed that the intermediary function reduces the risks and intermediation costs, and that it encourages the lenders to channel surplus funds to a much wider group of borrowers (Goacher et al, 1987). Consequently, economic growth may be facilitated by making it easier for riskier businesses and new ventures to obtain bank funding.

The small business sector, on the other hand, is indispensable because it employs a large percentage of labour force, provides a main source of income to millions of families and contributes substantial portions of the gross domestic product (GDP). The small businesses also make up a significant proportion of newly created jobs and contribute to the dynamics and development of industries and economies (Landstrom, Frank & Veciana, 1997).

The significant contribution of the small businesses to economic development in both the developed and developing countries is reflected in the following statistics: they are responsible for the creation of almost 70 per cent of new jobs in the United States (Pengelly, 1999), and contribute to more than 50 per cent of industrial output in Japan (File & Prince, 1992). They also provide work for over 68 million persons or two-thirds of the labour force in Europe (Wijngaarden & Horst, 1997). In Australia, the small business sector accounts for at least 85 per cent of the total enterprises, employs 45 per cent of the private sector workforce and contributes 33 per cent of the economy's gross domestic product (Watson & Everett, 1993). Among the developing countries, the sector constitutes 95 per cent of the industrial employment in Sierra Leone, 70 per cent in Nigeria, and 71 per cent in Tunisia (Hajjar, 1989). In the South East Asian region, small businesses dominate the Hong Kong economy, contribute to 79 per cent of the industrial employment in the Philippines, and account for more than 85 per cent of all business establishments in Singapore and Indonesia (Beng, 1989).

Therefore, the importance of the small business sector to the economy is now widely recognised. It has also been given an impetus when the World Bank started to shift resources to small-scale projects in the developing countries (Bannock & Binks, 1989). The Bank's policy paper states:

"The basic rationale for World Bank support to Small Scale Enterprises (SSEs) in developing countries is that SSEs play a major role in providing income and

employment to the urban poor and that past neglect and policy bias need to be corrected to give small enterprises a fair chance in comparison with large firms".

The support given by the World Bank is based not only on the contribution of small businesses to income generation and employment, but perhaps more importantly, to the following characteristics that the latter possess (Levitsky, 1989).

1. Entrepreneurship

Small businesses are typically run by their owners who tend to be former skilled workers or traders. As entrepreneurial talent is scarce in the developing countries, small businesses could effectively develop the limited entrepreneurship available. They are also the only means for a majority of entrepreneurs to enter the industrial sector and participate in the industrialisation process.

2. Industrial Dispersal

Urban concentration in developing countries is a major socio-economic problem. Since the small businesses need less social and physical infrastructure, the development of the sector would lead to a greater decentralisation of industry. Consequently, excessive migration of population from rural to urban areas can be prevented.

3. Technology Adaptation

Small businesses are more likely than large firms to use relatively simple, general-purpose equipment, better adapted to local conditions. The use of less sophisticated and more appropriate technologies is evident in their concentration in labour-intensive manufacturing activities.

4. Utilisation of Local Resources

In many developing countries, supplies of domestic raw materials are too limited for large-scale processing, but may be sufficient for small-scale operations. Because of their locational flexibility and lower requirement of infrastructure, they serve smaller geographical markets. Thus, small businesses can contribute not only to direct employment creation, but also to indirect job creation in the development of indigenous materials.

5. Linkages

As industrial development progresses, a symbiotic relationship develops between large and small industries. The latter tend to complement larger firms in supplying the required intermediaries and other inputs that would be uneconomic for the larger firms to produce, and serving the markets that are not attractive to them. This relationship can contribute towards industrial efficiency in the economy.

Traditionally, small businesses rely on commercial banks as the major source of external finance (Jones, 1982; Binks et al, 1992; Fletcher, 1995; Meyer, 1998; Strahan & Weston, 1998). The bank funds are needed to finance the day-to-day operations, purchase of capital equipment, and building needs. The small businesses do not have access to the capital market, especially where equity finance is concerned, and thus rely heavily on bank loans for both short-term and long-term needs (Memon, 1984; Apilado & Millington, 1992; Hancock & Wilcox, 1998). The bank's finance is also a critical factor for their growth and survival. However, it seems that the largest users of bank loans are always the commercial and industrial borrowers. The emphasis on large customers has sometimes led to a claim that the commercial banks are not sympathetic and tend to neglect smaller customers (Buerger & Ulrich, 1986). This has been compounded by the perceptions on the part of bankers that lending to small business is riskier and more costly than to bigger firms, and that small business loans are less profitable compared to larger ones (Churchill & Lewis, 1985).

The issue of finance availability to the small business sector has always attracted considerable attention from both academics and practitioners. It was first highlighted by the Macmillan Committee (1931) in the UK, which recognised the 'finance gap', a situation where a small business had great difficulty in acquiring longer-term finance. This gap has since come to be known as the 'Macmillan gap'. The Committee reported that:

"It has long been represented to us that great difficulty is experienced by the smaller and medium sized business in raising the capital which they may from time to time require, even when the security offered is perfectly sound. To provide adequate

machinery for raising long dated capital in amounts not sufficiently large for a public issue, that is, amounts ranging from a small sum up to say £200,000 or more, always represents difficulties".

Subsequent Committees also reported similar findings. The Radcliffe Committee (1959), for example, argues that the small businesses were unable to secure funds to finance new commercial innovations that require risky longer-term capital. The Bolton Committee (1971) suggests that the 'gap' was mainly in the form of information availability. However, it cited the three situations that justify the existence of the 'Macmillan gap', that is, the restrictions on credit, particularly of ceilings on bank lending, had a severe effect on small businesses; the difficulty in raising medium term finance in relatively small amounts (between £5000 and £50,000); and the ability to have access to the formal equity market putting them at a serious disadvantage.

The Wilson Committee (1979) set up to review the functioning of financial institutions to finance small firms reported a potential 'debt gap' that emerged due to an overly cautious attitude among banks, making them unnecessarily restrictive in their lending policies. The Committee also found that the terms offered to small firms were severe, and that the rates of interest of around two per cent higher than those charged to larger firms were too excessive. Furthermore, too much attention was given to security provision required for loan approval.

It is clear that small businesses encountered various problems in gaining excess to external finance. Despite a number of attempts that have been made to close the 'finance gap', the problem persists, especially in relation to bank finance (Stanworth & Gray, 1991). It is also the most pressing, since bank finance is the most commonly used by the small businesses (Binks et al, 1992). Read (1998) argues that the bank and small business relationship is problematic, and is frequently characterised by a negative feeling towards the bank. Chittenden et al (1995) found that small businesses are not only facing difficulty in obtaining bank finance, but are also being penalised on the terms on which the finance is offered. It is also felt that the banks are not only unsympathetic, but do not seem to have sufficient knowledge or understanding of how small businesses operate and of what their needs are (Wyant & Hatch, 1990). A recent newspaper article shares this view on how banks perceive their small business customers (Daily Mail, 1999):

"Banks often see small firms as too great risk. They are wary because they think that if the business gets into trouble the owner might disappear, leaving a trail of debts".

The existence of a 'finance gap' is still a running issue in the financing of small businesses, and obviously, this should be a cause of concern to the banking industry, and to the policy makers. The small business sector now constitutes a significant force in the economy, and if it experiences difficulties in obtaining bank finance, potential growth will be severely inhibited, and any constraint to its growth may have a profound effect on the country. On the other hand, the banks may also miss the opportunity of the emerging lucrative market if they fail to recognise the potential profitability that this sector provides. Studies by Kolari et al (1997) and Dunkelberg (1997) have revealed that, on average, banks earn higher profit rates on small business loans than on other assets. It was also found that when all costs and revenues from lending and bank services are combined with deposit relationships, small business lending becomes a very attractive source of income for the banks (Churchill & Lewis, 1985). Furthermore, the increasingly competitive environment, and the deregulation of the banking industry in many countries can lead to smaller margins, if all banks focus mainly on large customers. These customers too have a readily available alternative source of funding through the capital market, and hence have additional negotiating advantage. As a result, large business customers may no longer provide the profit potential they once did.

1.2 RESEARCH PROBLEM

A considerable amount of literature has provided an insight into an inherent problem among the fund providers that may contribute to the 'finance gap' of small businesses (Binks et al, 1992; Berry et al, 1993a; Deakins & Hussain, 1994). One theory that has been put forward is that relating to the environment under which the commercial banks operate. It suggests that these banks make lending decisions on small businesses under conditions of uncertainty and asymmetry of information (Binks et al, 1992; Amit et al, 1998). Under this condition, one party has certain pieces of information that have a material effect on a contract, but not the other party, and such a situation can give rise to a twin problem of moral hazard and adverse selection. In the former situation, the issue arises where the action of a small business borrower is not directly observable by the banker once he or she obtains the loan. This borrower may use the funds for other purposes which are personally profitable, but may be detrimental to the banker (Holstrom, 1979; Heffernan, 1996).

An adverse selection occurs because a banker cannot distinguish between the good risk and the bad risk borrowers (Cowling & Sugden, 1995). A small business owner when approaching the bank for a loan has always an informational advantage over the banker which leads him or her to overstate the soundness of his or her business proposition in relation to the funding sought (Storey, 1994). This problem sometimes affects the willingness of the banks to enter into contracts to supply the needed funds to small businesses.

Deakins & Hussain (1994) and Fletcher (1995) reiterate the difficulties facing the banks in overcoming the moral hazard because it is not economical to devote resources to appraisal and monitoring where the loans are relatively small. Deakins & Hussain (1994) also argue that because of adverse selection, bankers often make errors in their lending decisions on small businesses. To make their point, they categorise the adverse selection as TYPE I error and TYPE II error. TYPE I error is where a banker turns down a good business proposition which turns out to be a success, and TYPE II error where a banker accepts a proposition which turns out to be a business failure. The bankers may be concerned only with avoiding TYPE II errors and not TYPE I, as the latter will not affect them unless the banks failed to achieve their targets. These partly explain why some small business propositions which have high potential for growth and profitability are turned away by the banks.

Evidence also suggests that the approach taken by bankers in the lending decisions relating to small businesses are biased. In the UK, Deakins & Hussain (1994) found that the bankers placed great importance on the extent of gearing, financial asset information on both the business and personal assets of the owners, and justification of income generation. These bankers gave less emphasis to other factors that are equally important to the success of a business, such as business acumen of the owner, management skills and business training, efficient use of resources, and technical knowledge. Fletcher (1995) confirms that the lending assessment employed by bankers is a capital-based approach that emphasises exclusively on financial information, gearing and security. NEDO (1986) also found that bankers are excessively conservative in their attitudes to risk, and frequently require personal guarantees as security.

Meanwhile, Clay and Cowling (1996) argue that banks are often criticised for the lending decisions on small businesses that are not based on actual prospects of the business, but instead on the likelihood of the banks being collateralised and secured. Lambden and Targett (1993) contend that bankers seem much more concerned with how a loan would be repaid if the business failed, rather than with the prospects for success and greater future involvement with the small business customers. Similarly in Australia, the bankers have placed considerably more emphasis on the supply of collateral than on the evaluation of the business's prospects and the ability to repay the loan from the business operations (John, Dunlop & Sheehan, 1989).

Nielsen, Trayler and Brown (1995) conclude that, as a whole, bankers do not seem to understand totally the needs of small business customers. They suggest that maintaining the relationship and understanding small business customers can create a conducive and vibrant banking industry. Therefore, the bankers should be better prepared to assess applications for loans to the small business customers.

The above studies have highlighted the problems experienced by the small businesses in gaining access to adequate finance, particularly the problems pertaining to bank funding. The findings have also contributed significantly to the existing literature on 'finance gap', documented earlier by Macmillan (1931), Radcliffe (1959), Bolton (1971) and Wilson (1979). While most of these studies have been undertaken largely from practical and theoretical perspectives, there are a number of studies that provide empirical evidence that attempted to address the problems relating to the decision-making process of the bankers (Vyakarnam & Jacob, 1991; Binks et al, 1992; Berry et al, 1993a; Deakins & Hussain, 1994; Fletcher, 1995). However, most of these studies are found to have focused mainly on the economic perspective in the relationship, while the contextual aspects of the lenders were lacking (Read, 1998).

A further review of the literature also reveals that most of these studies have focused only on developed countries, and very little has been researched in the developing countries. The strong evidence suggests that the 'finance gap' exists too in these countries (Peterson & Shulman, 1987). Furthermore, understanding the issue becomes more important in view of the fact that attitudes differ from one bank to another, and from one country to another. Suarez (1980) succinctly points out these differences:

"Some banks are more conservative than others.........Banks have different concepts of loyalty to borrowing customers, and this is most important when the economic climate for borrowing becomes unfavourable.........The assessment of the risks in a loan situation is a matter of personal judgement. Bank lending officers are individuals; consequently they have different personalities, experience and outlook, and frequently form very different judgements on particular loan requests".

Given that there is a paucity of similar research in the developing countries, this study is therefore focusing on Malaysia, one of the leading emerging markets, as an attempt to fill the gap.

1.3 RESEARCH OBJECTIVES

The main objective of this research is to develop an understanding of the decision-making process of Malaysian bankers in lending to the small business sector. It is to contribute to an increase understanding of the decisions on lending to small businesses developed earlier by Ulrich & Cassel (1974), Ulrich & Arlow (1981), Binks, Ennew & Reed (1992), Berry, Faulkner, Hughes & Jarvis (1993a), Deakins & Hussain (1994) and Fletcher (1995), but found to be lacking in focusing on the non-industrialised countries. Since no such research had been conducted in Malaysia before, this study will be largely exploratory in nature.

Specifically, the research is designed to investigate how bank managers in Malaysia make decisions on lending to small businesses, to identify the relative importance of criteria used in assessing small business loan propositions, to gain insights into the lending practices of bank managers, and to explore their attitudes and behaviours when dealing with small business customers. It has been hypothesised that the bank lending decisions on small businesses are biased. This research will therefore hope to find out whether or not bank managers in Malaysia make the 'right' decisions when assessing small business propositions.

In addition, it is also the aim of this research to compare and contrast the findings with those of earlier studies and related literature. In what ways are the lending decisions on small businesses different from those of bankers in the industrialised countries? In what ways are they similar? It is hoped that this study will help fill a void in research dealing with the Malaysian context, and shed light on the issue in a different political, economic, social and cultural environment.

1.4 SIGNIFICANCE OF RESEARCH

The idea of carrying out research in the area of bank's lending decisions on small businesses occurred to the researcher for two main reasons. First, the issue of funding for small businesses has been the focus of longstanding and sometimes acrimonious debates among the authorities, bankers, small business community and media in Malaysia. Of particular interest, is the growing concern expressed by the relevant authorities:

"The First Finance Minister Tun Daim Zainuddin has expressed displeasure at the slow disbursement of ....funds set up to assist small businesses.......and warned that

the government would review the funds if a 50 per cent disbursement target is not attained by mid-May……….The government is only interested in the disbursement of funds. We are serious about it. We want to make sure the economy recovers and the small business sector plays a big role in that"

(The Star, February 12, 1999)

"Lack of social responsibility among bankers has been blamed as one of the main causes of the slow disbursements of loans under special funds for the small businesses…….the indifferent attitude of bankers was one of the main obstacles for the reluctance to disburse the loans".

(The Star, February 13, 1999)

"Banks should exercise greater flexibility in their collateral demands to expedite the distribution of loans to viable and deserving small businesses……….Bankers at branch levels (especially in small towns) were still not well-informed and trained about viable small business products".

(New Straits Times, July 17, 1998)

"The demand for Malaysian products in the international market was increasing but supply could not keep up because the small business sector had difficulty in obtaining loans".

(New Straits Times, August 2, 1998)

This research is not to satisfy the specific needs of any of the parties in the debate, but the findings will provide useful guidelines for planners and decision-makers in designing programmes to encourage active participation of the commercial banks in the development of the small business sector.

Secondly, in the light of the literature's failure to present similar research in the non-industrialised countries, the findings of this research should contribute to an increased understanding of the bank's decisions on lending to small businesses. Therefore, understanding the issue can help improve the relationship between the commercial banks and small businesses in the future.

1.5 ORGANISATION AND STRUCTURE OF THESIS

In this section, a brief description of the organisation of the thesis will be given. As explained earlier, Chapter One has identified the 'gap' in the literature, and has suggested some strong reasons why research on the bank lending decisions on small businesses needs to be undertaken. The rest of this thesis contains another six chapters, organised and structured in the following manner:

Chapter Two provides the country setting, including an overview of Malaysian geographical and demographic characteristics, and economic development. It also focuses on the description and development of the small business sector, and some of the constraints that may inhibit its growth potential. The chapter also discusses the contribution of commercial banks in the general development of the Malaysian economy, and the small business sector in particular.

Chapter Three provides an overview on some of the theories of decision-making. The purpose of this chapter is to generate an understanding and appreciation of the issues in decision making that may need to be addressed in the later chapters. The chapter focuses on the definitions and a variety of forces that influence and shape an individual and an organisation in making decisions. A number of decision-making models found in the literature are presented. There is also a discussion on the issues of rationality, heuristics and quantitative models employed in making decisions.

Chapter Four reviews the literature on bank lending decisions from both the theoretical and practical perspectives. The discussion covers areas such the general principles of lending, the approach to the lending decision from the US and UK perspectives, the quantitative and qualitative techniques employed in the lending assessment, and the theoretical underpinnings and practical approach to the small business lending.

The research methodology employed in the research is presented in Chapter Five. It begins with a general discussion on the types of research methods available, and on the continuing debate on qualitative versus quantitative research. This is followed by a description of the choice and rationale of the research design, the sampling choice, the data collection procedure employed, and the process of data analysis used. The limitations of the study are also highlighted.

Chapter Six presents the analysis and findings of the study. The discussion of the chapter focuses on the two components of analysis. The first component is the interpretation of lending decisions on the business propositions. It consists of the demographic characteristics of the respondents under study, and the scoring on the business proposition. The second is the rating of perceptions based on a set of criteria normally used by bankers in assessing new ventures, and the existing small businesses. Finally, the conclusions, research implications and suggestions for future research are drawn together in Chapter Seven.

CHAPTER TWO

2. MALAYSIA: ECONOMIC, SMALL BUSINESS AND COMMERCIAL BANKING DEVELOPMENTS

2.1 INTRODUCTION

This chapter begins with a general introduction to the geographical and demographic characteristics of Malaysia, and a discussion of its economic policies and developments. It examines the contribution of the manufacturing sector as an engine of growth that has radically altered the economic structure of the country from a largely agriculture-dominated to a more industrialised-based economy.

The second part of the chapter focuses on the developments and problems of the small business sector. It reviews the still unresolved questions of definitions, the developments and contributions of the sector to the economy, and the constraints that may limit its growth potential. This section also seeks to assess the importance of the small business sector to the process of industrialisation.

The final part of the chapter analyses the relative importance of commercial banks in the general economic development of the country, and in the development of the small business sector in particular. The discussion will also focus on the existence of a 'finance gap' in the availability of bank funding that inhibits the growth potential of small businesses. The purpose here is to uncover whether there is evidence of small businesses actually being denied access to a bank loan, and if so, in what ways it might need to be rectified to ensure that small businesses will have adequate access to the funds.

2.2 BACKGROUND

Malaysia is a relatively small country located in the South East Asia region, with a total land area of about 330,000 square kilometres. The country consists of two distinct regions, namely Peninsular Malaysia (132,000 square kilometres), and Sabah and Sarawak (198,000 square kilometres). Peninsular Malaysia has its frontiers with Thailand in the north and Singapore in the south, while Sabah and Sarawak border the territory of Indonesia's Kalimantan.

The country's population of about 22 million is multiracial, comprising 62 per cent Malays and other indigenous people (together they are referred to as the Bumiputera community), 27 per cent Chinese, 8 per cent Indians and 3 per cent others (Statistics Dept, 1997). About 82 per cent of the population live in Peninsula Malaysia, where the density is 116 persons per square kilometre compared with 22 persons in Sabah, and 14 persons in Sarawak (BNM, 1994).

The economy of Malaysia is essentially trade and industry-oriented. When the country gained independence from Britain in 1957, its industrial development was backward and the country's main economic activity depended heavily on the growth of two major industries, namely tin and rubber industries. Indeed, these two industries were the cornerstone of economic development and provided a major source of employment and gross domestic product (GDP). The manufacturing sector then was still in the infant stage.

However, from independence, considerable encouragement was given to the manufacturing sector, and during the 1970s, the government embarked on a deliberate strategy for industrialisation. The rationale for this industrialisation was that there was a need to diversify the economy due to the instability of world prices for primary commodities, and to encourage the development of resource-based and labour-intensive industries so as to create more employment opportunities for the growing labour force. Various fiscal incentives were created to stimulate industrial growth, and this has resulted in massive inflows of investments from abroad. Undoubtedly, foreign investments were the major force behind the expansion of the industrial sector. They brought with them high technology, managerial skills, capital, and established world-wide markets. As a result, the manufacturing sector became the fastest growing sector of the economy, surpassing the traditional mainstay, the agricultural sector. During the period 1970-80, the sector grew at an average rate of 8.3 per cent of GDP (MIDA, 1993).

The process of industrialisation had been tremendous. The manufacturing sector grew further to an average of 14.5 per cent per annum in the 1980s, and an average of 13.5 per cent in the early 1990s. This accelerated growth was aided greatly by the implementation of the Industrial Master Plan (IMP) in 1986. The Plan was a blueprint for the development of the manufacturing sector over a ten-year period. It recommended an outward-oriented industrialisation strategy based on (a) the intensive development of the resource-based industries for export, and (b) the diversification of non-resource based industries for export as well.

The past two decades have seen remarkable progress made in the economic development of Malaysia. The country has achieved a continuous growth rate of above 8 per cent every year since 1988. The changes in the industrial structure have been substantial, and the industrial sector has since been targeted as the main thrust of economic growth through strengthening the manufacturing base, and diversifying the export of manufactured goods. In the long run, the government's emphasis is on higher technology and heavy industries, in line with the aim to achieve an industrialised country status by the year 2020.

There was, however, a major hiccup in the growth of the manufacturing sector when the financial crisis in the mid-1997 had severely affected the country. As a result, the country's economy saw a negative growth of 6.7 per cent in 1998, while output of the manufacturing sector for the same period, contracted by 10.2 per cent (The Star, 1999c). Nevertheless, the sector has since shown a remarkable recovery when it registered a growth rate of 10.4 per cent for the second quarter of 1999 (The Star, 1999f). Therefore, the manufacturing sector would continue to be the dominant sector of the economy, and it should lead the country out of the economic difficulties.

It is also interesting to note that the small business sector has been suggested to play a more significant role in the aftermath of the crisis (NST, 1999; The Star, 1999c). It is believed that small businesses are able to withstand economic crises better than large firms. Being small, they have low overheads and are quick to respond to changes in market conditions. Furthermore, they are less vulnerable to external economic fluctuations than larger firms. Therefore, strengthening this sector can also be a contributing factor to the industrialisation process.

2.3 ECONOMIC POLICY

The economic development of Malaysia is guided by a policy commonly known as the New Economic Policy or NEP. It was introduced in 1970 after the country suffered serious racial riots in 1969, largely attributed to the disparity in wealth distribution among the ethnic groups in the country. This tragic event prompted the government to re-orientate the economic policy towards promoting racial unity as its main objective. It was the main aim of the NEP to eradicate the poverty among all ethnic groups, and to restructure the society so as to eliminate the identification of race with economic functions.

The broad socio-economic framework of the NEP was set out under the First Outline Perspective Plan (OPP1), and consisted of four five-year development plans covering the period of 1970 -1990. The first prong of the NEP strategy was to eradicate poverty, irrespective of races. When it was launched in 1970, the incidence of poverty in Peninsular Malaysia stood at 49.3 per cent of total households. The target then was to reduce it to 16.7 per cent by 1990. In terms of ethnic groups, the incidence of poverty among the Bumiputera was highest at 65 per cent, compared with 26 per cent for the Chinese and 39 per cent for the Indians (Malaysia, 1991).

The second prong of the NEP strategy sought to restructure the society by eliminating the identification of race with economic functions. This objective was to be achieved through the restructuring of employment pattern, ownership of share in the corporate sector, and the creation of the Bumiputera Commercial and Industrial Community (BCIC). It was targeted that the Bumiputera would own and manage at least 30 per cent of the total commercial and industrial activities of the economy, compared to only 2.4 per cent in 1970. By the end of the NEP period, significant progress was made in the alleviation of poverty among the various ethnic groups. It also saw an increase of Bumiputera participation in the economy.

Building on the achievements of the OPP1, the Second Outline Perspective Plan (OPP2), covering the period of 1991-2000, was formulated. It was based on a policy known as the New Development Policy (NDP). The formulation of the NDP set a pace for the country to become a fully developed economy by the year 2020. The NDP maintains the basic strategies of the NEP, but with a new dimension (Malaysia, 1991). The strategies are to:

1. Focus more on eradication of hardcore poverty while at the same time reducing relative poverty.
2. Focus on employment and rapid development of an active BCIC, as a more effective strategy to increase the meaningful participation of Bumiputera in the modern sectors of the economy.
3. Rely more on the private sector to be involved in the restructuring objectives by creating greater opportunities for its growth.

4. Focus on human resource development as a fundamental requirement for achieving the objectives of growth and distribution.

The launching of the Seventh Malaysia Plan in 1996 saw the Malaysian economy entering the second phase of the OPP2. Although the financial crisis of mid-1997 had affected the programmes laid down under the OPP2, significant progress was made in addressing problems of poverty, income inequality and unemployment opportunities. It is reported that the incidence of poverty among Malaysians had been reduced from 8.9 per cent in 1995 to 6.1 per cent in 1997 (Star, 1999d).

To sum up, the Malaysian economy had experienced a relatively long period of robust growth following the late-1980s. This achievement was largely attributed to a conducive climate in the country built upon by a concerted effort of the government towards industrialisation. It has also transformed the economic structure from being mainly agriculture-based to having more emphasis on the manufacturing sector. However, the regional financial crisis had led to a sharp decline in the economic growth, and this had provided a major set back to the country's process of industrialisation. The impact of this crisis is still being felt in all sectors of the economy. Notwithstanding, there is one sector that needs to be given a more significant role. The small business sector has been known to exert a strong influence on the economic development of a nation. It is often argued that the sector is also more flexible and less prone to external shock than the larger firms (Bruch & Hiemenz, 1984). Moreover, it can contribute to the process of industrialisation by acting as a link in the chain of intra-industrial linkages, which are preconditions for establishing a competitive manufacturing industry. Therefore, the development of the small business sector in Malaysia not only contribute to employment, output and provide a wide range of business opportunities, but will also help in revitalising the economy.

2.4 SMALL BUSINESS SECTOR: GENERAL VIEW

2.4.1 Definitions

Understanding the small business sector and its contribution to the economy is not complete without identifying the still unresolved question of what really constitutes a small business. There is no specific and universally accepted definition of a small business. Definitions can depend on the country's stage of development, policy objectives and administrative patterns (Beng, 1988). Accordingly, this definition varies as each country embraces different criteria that best suit its structure, and it may change over time. The Georgia Institute of Technology for example, found at least 60 different definitions used in 70 countries, while the United States Congressional Committee was presented with 700 definitions (Watson & Everett, 1993).

Generally, there are two common approach to defining the small business. The first is a functional definition in which the small businesses are distinguished from the larger ones on the basis of suspected or proven characteristics. For example, a definition by Watson & Everett (1993) states that:

"a business in which one or two persons are required to make all the critical management decisions in finance, accounting, personnel, purchasing, processing or servicing, marketing, selling, without the aid of internal specialists and with specific knowledge in only one or two functional areas".

Other researchers, such as Ang (1991), suggest that a business is classified as small if it possesses most of the following characteristics: (a) it has no publicly traded securities, (b) the owners have undiversified personal portfolios, (c) limited liability is absent or ineffective, (d) first generation owners are entrepreneurial and prone to risk-taking, (e) the management team is not complete, (f) the business experiences the high cost of market and institutional imperfections, (g) relationships with stakeholders are less formal, and (h) it has a high degree of flexibility in designing compensation schemes. Storey (1982) categorises a small business as having a small share of the market, being managed by the owners rather than by employees on behalf of the shareholders, and having owners who are legally independent in taking their decisions.

On the other hand, the Committee for Economic Development Standard (CED) considers a business as small if it satisfies two of the four following: (a) management is independent, (b) capital is supplied and ownership is held by an individual or a small group, (c) the area of operation is mainly local, owners and workers are in one home community, and (d) the business must be small when compared to the biggest unit in the given field (Scarborough & Zimmerer, 1984).

A small business is also defined as a business in which there is no public negotiability of common stock, and the owners must personally guarantee any existing or any planned financing. Osteryoung & Newman (1993) elaborate:

"This definition specifies the marketability of the firms equity. When a firm has public stock, then there is a significant degree of sophistication required over a private firm. Additionally, the valuation of publicly held stock is quite easy to ascertain, while the valuation of a privately held firm is very difficult. The definition also recognises the owner's personal guarantees on any debt obligation. The reasons for personal guarantees are to ensure that the funds are repaid. With small businesses, the threat of bankruptcy risk and the ability of the lender to control internal operations of the firm, mandate the need of personal guarantees".

They further argue that a definition of small business must have three criteria, that is, it must be measurable and observable, it must be congruent with the perceptions of the market system, and it must be meaningful.

The Bolton Committee (1971) classifies the business as being small if it satisfies the following three characteristics:

1. A relatively small share of the market place.
2. Managed by the owner or part owner in a personalised way, and not through the medium of a formalised management structure.
3. Independent, in the sense of not forming part of a large enterprise.

The second approach to the definition of a small business employs some quantitative measures, such as number of employees, sales turnover, level of output or capital assets. The definition of a small business according to the number of employees normally ranges from less than 50 to less than 1000 employees (Osteryoung & Newman, 1993).

The Bolton Committee (1971) also categorises small businesses according to sectors, that is, those of manufacturing with 200 employees, construction, mining and quarrying with 25 employees or fewer, those of retailing and services having an annual turnover of £50,000 or less, motor trades with a turnover of £100,000 or less, and wholesale trades with turnover of £200,000 or less.

Meanwhile, the European Union (EU) adopts a different approach in defining a small business (EC, 1996). In order to be considered an SME, an enterprise must have less than 250 salaried workers. A business is considered to be a 'medium sized enterprise' if it has 49 and 250 employees and an annual turnover of under 40 million Euro. A 'small' enterprise must have less than 50 employees and an annual turnover of less than 7 million Euro, while a 'very small' enterprise is a business with less than 10 employees. In addition, the SME cannot have 25 per cent or more of its control in hands of a large enterprise or jointly held by several large enterprises.

In the United States, the Small Business Administration (SBA) defines a small business as having less than US$10 million annual sales, with less than 1000 employees, and does not dominate the industry (Eckert, Ray & Ryan, 1990), while the White House Conference on Small Business considers it to have less than 500 employees (Scarborough, Norman & Zimmerer, 1984). Giles (1993) uses the annual sales and number of employees of up to US$10 million and less than 500, respectively. Those businesses with annual sales of up to US$500,000 and having 5 or fewer employees are categorised as micro-businesses.

It can be seen that both approaches to the definition of small business can still differ when examined at sectoral or country levels. In some sectors or countries, the business may be regarded as small, while in others there is a possibility that it may not be categorised as small. Therefore, to choose the most suitable definition is to take into consideration that it must serve the purpose, and the location of where the study is to be conducted (Hajjar, 1989).

Not surprisingly, there is also no standard or legal definition of small business in Malaysia. But various criteria have been used to classify the business for the purposes of assistance. The Small and Medium Industries Development Corporation (SMIDEC), an agency under the Ministry of International Trade and Industry (MITI), defines it as a manufacturing enterprise with a shareholders' funds of less than RM500,000 or employs a full-time workforce of fewer than 20 workers. An enterprise with shareholders' funds of between RM500,000 to RM2.5 million, and employing between 20 to 100 workers is considered as a medium-sized business.

The World Bank study on Malaysian industries considers the small business enterprises as those employing between 5 to 49 full-time employees, and the medium-sized enterprises as having between 50 and 199 employees (UNIDO, 1990). The Industrial Coordination Act (ICA) defines it, based on the size of shareholders' funds. A small firm is a business with less than RM500,000 of shareholders' funds, and a medium-sized business has funds ranging from RM500,000 to RM2.5 million.

For the purpose of this study, the term "small business" is used to indicate small and medium-sized enterprises (SMEs) or industries (SMIs). This study adopts the definition employed by the central bank (Bank Negara Malaysia or BNM), that is, those registered businesses with net assets of up to RM2.5 million, or in the case of limited companies, with shareholders' funds of not more than RM2.5 million. The small business sector therefore refers to all businesses that fulfil the above definition of the central bank. A great majority of these businesses are independently owned, and operated by individuals and families.

2.4.2 Small Business Development

Evidence suggests that the contribution of the small business sector to the economy in the industrialised countries has been long recognised (Auken & Carter, 1989; File & Prince, 1992; Watson & Everett, 1993). However, in Malaysia, the contribution of the small business sector only began to emerge in the late-1960s. It was during this period when the government recognised the need to assist in solving the problems of the businesses, especially of those owned by the Bumiputeras. The main concern of the government, then, was to promote the economic activity of the Bumiputera community. This assistance was expanded rapidly under the Second Malaysia Plan (1971-1975), when the New Economic Policy (NEP) was launched. The emphasis was to include developing Bumiputera entrepreneurship, increasing production and employment, ensuring higher incomes for the largest and poorest segments of the population, and achieving regional dispersion of businesses and industrial activities in order to secure better use of natural resources.

By the time the Third Malaysia Plan (1976-1980) was implemented, the small businesses had been acknowledged as training ground for future entrepreneurship, and as a means for restructuring the racial economic imbalance. The important roles played by these businesses were further emphasised under the Fourth Malaysia Plan (1981-1985), especially in training, savings, mobilisation of resources, entrepreneurship development, and inter-industry linkages. It was during this period that the Small Enterprise Division (SED) was established under the Ministry of Trade and Industry. Following this, a Division of Small-scale Industry was also set up in the Ministry of National and Rural Development.

During the Fifth Malaysia Plan (1986-1990), the Industrial Master Plan (IMP) was launched, and the manufacturing sector was reorganised from a domestic-oriented sector to one export oriented. By this time, the emphasis of the small businesses was on expansion, improvement and modernisation through the introduction of an incentive system, R&D development, and the strengthening of the agencies responsible for the development of the manufacturing sector.

Under the OPP2, the small business sector was further promoted and upgraded, with the objective of making it an important and viable vehicle for industrial expansion, and the creation of inter-industry linkages and support. This sector was expected to contribute significantly in terms of value-added and labour absorption in the manufacturing sector. Several government agencies were drawn in to promote these businesses through provision of support services, such as training, advisory, extension and R&D related services, as well as marketing assistance.

The setting-up of the Small and Medium Industries Development Corporation (SMIDEC) in 1996, replacing the Small Enterprise Division (SED), was a further step by the government to spearhead the promotion and development of the small business sector into becoming a dynamic and efficient support and ancillary industrial sector. The programmes developed by SMIDEC include fostering industrial linkages and integration with large firms, acquiring appropriate technology and developing in-house indigenous R&D capabilities, and developing a pool of qualified technical and managerial skills.

Beside these programmes, various funds were also launched by the government to enable the small business sector to have wider access to financing on attractive terms and conditions. These include the Industrial Technical Assistance Fund (ITAF), the Integrated Marketing Programme for the Food Industry, the Soft Loan Scheme for Modernisation and Automation, and the Soft Loan Scheme for Quality Enhancement. In addition, special funds were created, such as the RM1.5 billion funds channelled through designated banks throughout the country, and the RM1.0 billion through the Credit Guarantee Corporation (CGC). Therefore, the special attention given by the government to the small business sector demonstrates the recognition of its important role in economic development.

2.4.3 Constraints of Small Businesses

Despite the continued effort by the Government to enhance the development of the small business sector in Malaysia, its overall performance is still far from satisfactory. In 1997, the small business sector contributed only 17.8 per cent to the product added-value which is relatively insignificant, considering it represents nearly 84 per cent of the manufacturing sector (NST, 1997). It is said that this sector is fraught with a variety of problems. The main problem is commonly associated with the nature of its size. This problem can range from lack of managerial skills to the use of outdated technology. However, the sector is also confronted with some extraneous problems, and the most common is the inadequacy of finance. A survey undertaken by the Tokyo Institute of Developing Economies in collaboration with the University of Malaya in 1986, reveals that more than 50 per cent of the entrepreneurs ranked inadequacy of financial resources as their most crucial business difficulty. This crucial inadequacy arises from the small sizes of the businesses, which are traditionally family type, and which commenced with personal savings or loans from friends and relatives. In fact, 80 per cent of the firms surveyed list own funds as a major source of financing.

Salleh (1990), Nawawi et al (1990) and Faridah et al (1990) found the problems as inadequate financial support, lack of technical know-how, limited market, and inadequate linkages with large industries. Chee (1986) identified finance, inadequate land for building, shortage of labour and lack of raw materials as some of the constraints to small business growth. Meanwhile, Hameed (1995) found a lack of working capital as a major problem, followed by marketing, personnel, production, availability of raw materials, general management, and government regulations.

The unavailability of finance has been the most frequently cited problem encountered by small businesses in Malaysia, and it is also a crucial issue to many of them (MITI, 1990). The financing requirement is essential to expand production capacity, purchase of materials, upgrade technology, and also to provide credit to customers. This lack of finance can cripple the growth prospects of the businesses (UNIDO, 1990). The inability to raise finance by small businesses is due to limited access to bank credit. It is generally accepted that due to its size, the small business does not have access to the capital markets, especially where equity finance is concerned. Thus, it relies heavily on bank loans for both short-term and long-term needs, and for financing the operating needs of new and existing businesses (Memon, 1984; Apilado & Millington, 1992).

Although substantial funds have been allocated to the commercial banks to be channelled to this sector, there seems to be a reluctant among the small borrowers to apply for these funds. Lee (1998) argues on the lukewarm response from the bankers who appeared to view any small business application as a potential portfolio of non-performing loans. This viewpoint may be attributed to what is perceived as inefficiency in small loan processing, and biases in assessing credit worthiness of small business customers by Malaysian bankers. As pointed out earlier, this problem may be exacerbated by the negative attitude and lack of knowledge and understanding among these bankers on the nature of small businesses.

The above discussions have highlighted the non-availability of external finance as one of the major reasons that may inhibit the growth potential of the small businesses. Although research on the issue is in abundance, there seems to be a focus mainly on the users, and less effort has been made to understand systematically the process of making decisions among the providers, notably the bankers. Obviously, decisions on the availability of the funds are likely to be determined by these bankers themselves. What motivates them to lend to the small businesses? What criteria do they take into account in deciding to accept or reject the small business loan proposition? As a result, planners and decision-makers can seldom find guidance from the existing literature when formulating policies pertaining to the small business sector. There is therefore a need to study the lending decisions of bankers when dealing with the small business proposition. This study will not only enrich the existing literature, but may also increase understanding on the problems of unavailability of finance to the small business sector.

2.5 DEVELOPMENT OF COMMERCIAL BANKS

2.5.1 Background

The origins of a banking system in Malaysia can be traced to the mid-1800s during the colonial period, when the commercial banks, commonly known then as the "exchange banks", were established. They were so-called because of the nature of their business, which was concentrated mainly in foreign exchange dealings, such as remitting and receiving funds, and trading in commercial bills. These banks were established to facilitate the growing trade with Europe and the Far East, and they were either the branches of British banks or other foreign-owned banks. The local bank was not in existence then, and only emerged in early-1900s, with the incorporation of the Kwong Yik (Selangor) Banking Corporation in 1913 (BNM, 1989).

During those periods, the financial market was not developed, the banking system was loosely structured, and the activities of the banks were mainly confined to financing big businesses or those that were involved in international trade. Sources of funds for small businesses came mainly from family and friends.

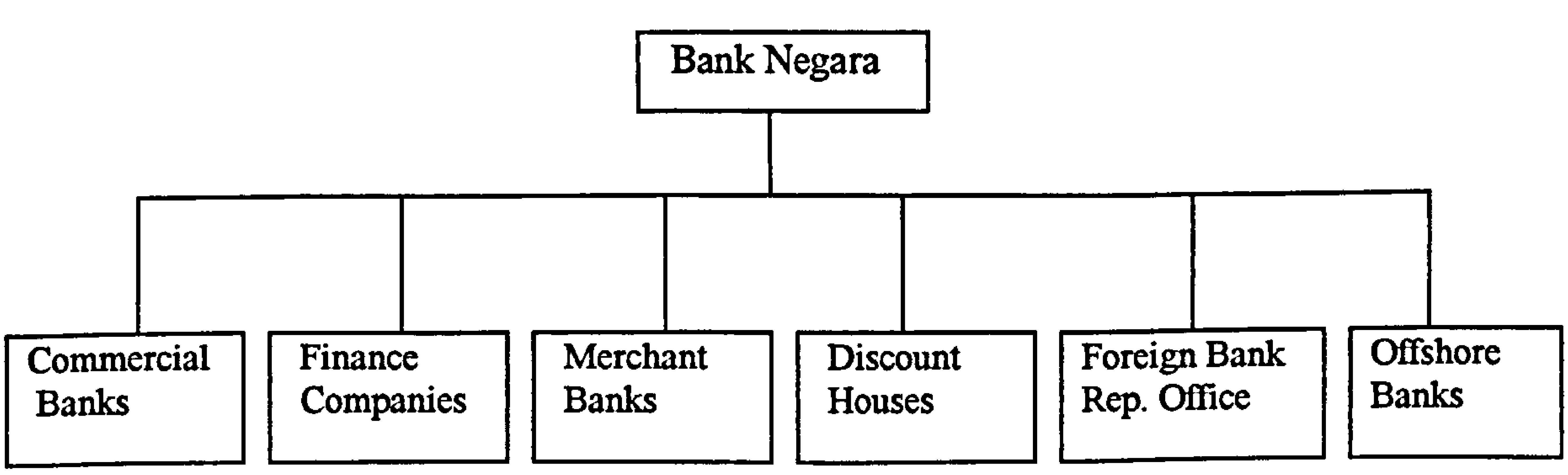
The establishment of Bank Negara Malaysia (BNM), or the central bank, in 1959 set a new era of banking in the country. As a regulatory authority, it is responsible for the monetary policy and management of the country's financial system, it issues notes and currency, and is keeper of national reserves, acts as a banker to the banks, and as fiscal agent for the government. This has helped the economic development of the country. As the economy progresses, people become more affluent, and more opportunities are created. Consequently, there will be a greater demand for more sophisticated banking facilities.

To ensure that these objectives are met, the BNM is vested with comprehensive legal powers, first under the Banking Ordinance (1959) and Banking Act (1973), and now under the Banking and Financial Institutions Act (1989) or (BAFIA). The latter Act is also for the purpose of controlling, regulating and supervising various financial institutions in the country.

Over the last four decades, the development of the financial environment in the country had been spectacular. One of the most important outcomes is a profound change in the banking system, with the establishment of a variety of financial institutions that offer not only competitive but also complementary banking services. It is no coincidence that the British legacy has left Malaysia not only with a well-developed legal system based upon the common law of England, but also the banking system, which to a considerable extent, follows the British system.

The system is now fully structured, with Bank Negara at the apex as a central bank, and under it the commercial banks, merchant banks, finance companies, discount houses, foreign banks' representative offices and offshore banks. The structure is shown in Figure 2.1 below:

Figure 2.1 Structure of Malaysian Banking System



Source: BNM Annual Report (1994)

Commercial banks form the largest and the most important group of financial institutions in the country. They are distinct from other institutions in the following functions (Peng, 1998):

1. Commercial banks possess the exclusive right to operate current account facilities where payment can be effected readily through the issue of cheques.
2. Commercial banks have the exclusive right to deal in foreign remittances and in international trade payments.
3. Commercial banks are the only institutions authorised to handle foreign exchange dealings.

The environment in which the commercial banks operate is often complex and changes rapidly. The emergence of new technology and the ever-changing and sophisticated needs of the customer have intensified the already highly competitive markets. Commercial banks are not only locked in fierce competition among themselves, but also with other financial institutions offering similar products and services. Marsh (1988) highlights a number of changing environmental forces that offer both new opportunities and threats to the commercial banks:

1. Customers are becoming more demanding and the relationship between the banks and customers is changing. Loyalty can no longer be taken for granted, as these customers often demand higher quality service and given added-value to justify premium prices.

2. Banks can no longer have some markets for themselves, and the markets are not necessarily where they used to be. Markets are now where the customers are, not where the banks are situated. Furthermore, customers have various choices to shop around for similar banking services.

3. The branch network remains an important distribution system and will continue to offer tremendous potential for those customers requiring contact. Introducing new services and new delivery systems will continue to be important, so too will be the image and identity, with a degree of distinctiveness that these new services will reinforce. Technology can also be used to improve customer convenience.

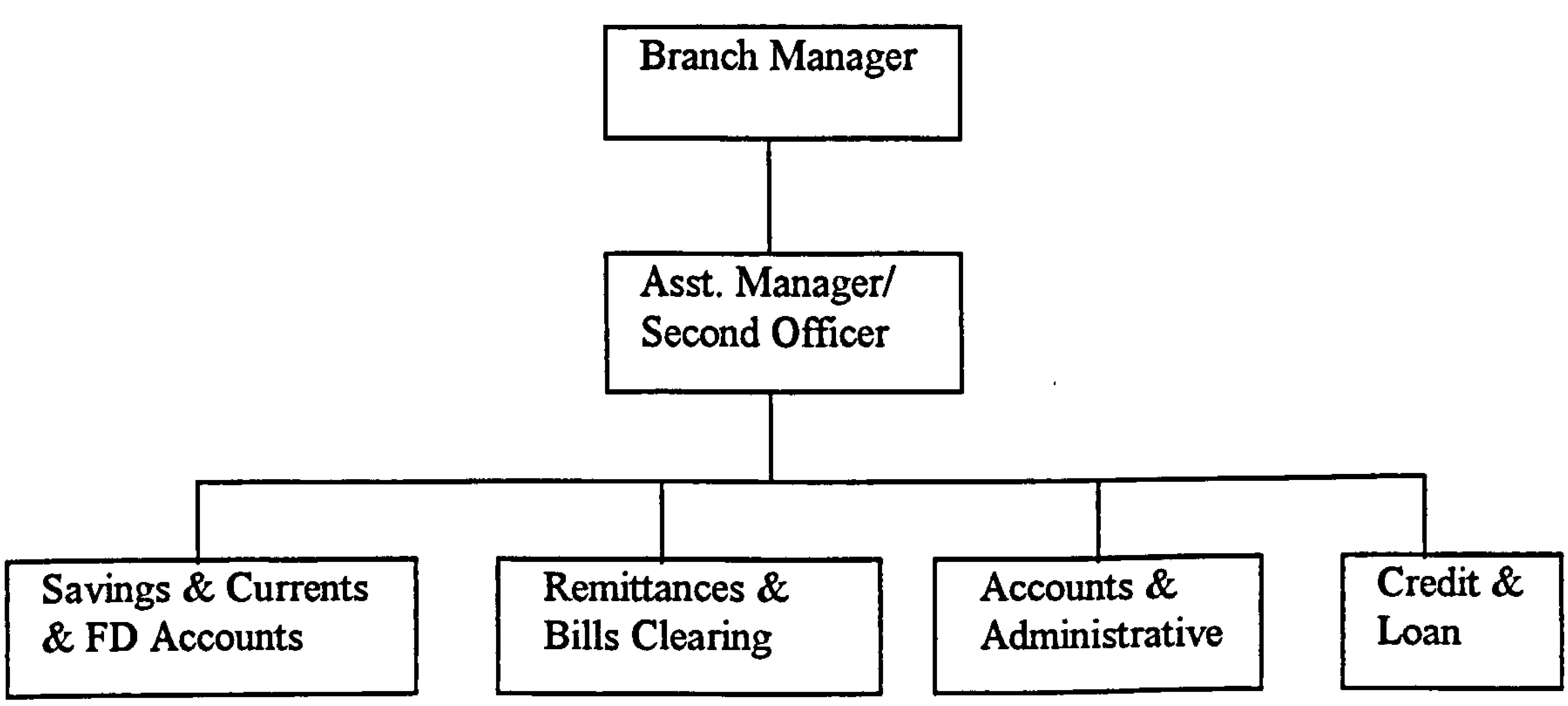
4. The pressures on profit clearly need a strategy for tighter cost. Thus, the banks need to service customers in less expensive, non-traditional ways, based on innovation and technology.

Operationally, the commercial banks are coping with challenges by increasing activity at the branch level. This is perhaps due to a bulk of small business customers who come to transact their financial affairs at this branch level. Thus, commercial banks are well placed to extend their activities, as branch networks have now expanded to provide banking facilities.

In Malaysia, most of the locally-owned commercial banks have extensive branch networks, even in rural areas. The rapid expansion of this branch network was largely attributed to the policy of the central bank, which legislated the approval of setting-up of new branch offices as a means to reinforce its effort to foster the development of local banks. These branches have the necessary qualifications and staff to manage the offices, and often have funds to lend and are anxious to identify new lending opportunities. The branch personnel, notably the managers themselves, are often seen to play a major part in the decision-making process for most of the loan applications to the banks. Furthermore, they have a better understanding, and tend to appreciate the local issues better than those at the head office, and this is thought to be useful in the lending decisions.

The basic characteristics of the branch banking system is that various operations are controlled from the head office, though obviously the degree of managerial independence delegated to branch managers varies considerably. Typically, the structure of a Malaysian bank branch is depicted in Figure 2.2 below:

Figure 2.2 Structure of Malaysian Bank Branch



Source: Ismail & Keang (1992)

The role played by the bank branch managers in the process of making decisions is obviously an important one. However, the approval authority could differ widely from one branch manager to another. A manager of a relatively large branch will have more authority to approve loans than a manager in a rural area, where his or her bank might be the only one operating. The former may need a fast decision-making procedure because of the nature of the environment, which is more competitive. Nevertheless, a study found that some of these managers are not satisfied with the limited authority accorded to them with regard to approval of loans. They feel that the lending decision process is too centralised at the head offices so much that delays in approving requests from their branches may result in souring the relationship with customers (Ismail & Keang, 1991). Another study also revealed that branch managers of banks in Malaysia are not given much freedom in major decision-making policies, which are mostly decided at the head office level (Mahmood, 1996).

Undoubtedly, the bank branch managers' roles remain important in meeting the needs of customers. They are the frontline personnel whom the customers may have had to approach when dealing with the banks. Thus, an investigation into the bank branch managers' decision-making processes can provide some insights on the manner in which business loan applications, especially those from small business customers, are determined.

2.5.2 Commercial Bank Lending

Commercial banks are the most important mobiliser of resources, accounting for 67.7 per cent of the private deposits placed with the financial system, and 60.0 per cent of total assets of the banking system (BNM, 1997). Since 1959, the growth of the commercial banks' total assets has been phenomenal. In nominal terms, these assets grew nearly six-fold in 10 years from 1987 to 1997 (See Table 2.1 below).

Table 2.1 Commercial Banks' Total assets (in millions)

1959	1967	1977	1987	1997
RM1,067.1	RM3,016.3	RM16,193.1	RM84,720.2	RM486,600

Source: Bank Negara Report (1997)

Lending is the cornerstone of a commercial bank's business, and it provides a bulk of the bank's earnings. Although competition has become more aggressive, commercial banks are still the major contributors of funds to various sectors of the economy with total loans in 1995, 1996 and 1997 amounting to RM182,078 million, RM228,256 million, and RM289,746 million, respectively. The lending to the economic sectors is shown in Table 2.2 below.

Table 2.2 Direction of Commercial Bank Lending (in millions)

	1995		1996		1997	
Loans by Sectors	RM	% share	RM	% share	RM	% share
Agriculture	3,859.7	2.1	4,064.6	1.8	5,917.6	2.0
Mining & Quarrying	885.5	0.5	608.9	0.3	786.8	0.3
Manufacturing	42,344.2	23.3	47,099.1	20.6	54,931.7	19.0
Electricity	3,580.6	2.0	4,146.0	1.8	3,888.8	1.3
Property	53,170.3	29.2	76,701.7	33.6	101,443.7	35.0
Wholesale, Retail, Restaurant & Hotel	19,043.0	10.5	24,009.2	10.5	29,224.0	10.1
Transport, Storage & Communication	2,986.4	1.6	4,411.8	1.9	8,616.8	3.0
Financing, Insurance & Business services	23,707.2	13.0	24,564.4	10.8	28,349.4	9.8
Other services	3,822.7	2.1	5,297.4	2.3	4,533.1	1.5
Miscellaneous	28,679.1	15.8	37,353.2	16.4	52,054.4	18.0
Total Loans	182,078.7	100.0	228,256.3	100.0	289,746.3	100.0

Source: Bank Negara Report (1997)

The above figures show a substantial increase of 25 per cent in commercial bank lending for 1996, and a further 27 per cent in 1997. The most significant increase was in the property sector, which shot up to 44.2 per cent in 1996, and 32.2 per cent in 1997. This sector also received the single largest portion of the total loan extended by commercial banks from 29.2 per cent in 1995, to 33.6 per cent in 1996, and 35.0 per cent in 1997. The growth in loans to this sector reflected the robust construction activities during those periods. Loans extended to the manufacturing sector also show significant increases of 11.2 per cent in 1996, and 16.6 per cent in 1997. However, in terms of share percentage of total loans, it shows a declining trend for the three consecutive years of 23.3 per cent (1995), 20.6 per cent (1996) and 19.0 per cent (1997), respectively.

The commercial bank lending activities during this three-year period to some extent did not seem to reflect the government's objective to strengthen the manufacturing sector as an engine of economic growth, as outlined in the OPP2. A big portion of loans went to finance speculative assets, and not those that are considered productive. In terms of percentage of total loans, the share to the manufacturing sector fell as compared to the construction activities. The excessive lending to the latter sector was, perhaps, one of the main reasons that contributed to the financial crisis that the Malaysian banking industry is now facing. One major explanation is that these banks seemed to be infected by a so called 'lemming syndrome' which reappears regularly when heavy losses occur as a result of some banks rushing into a fashionable market, and in so doing abandoning all their normal credit assessment procedures (Channon, 1986). By December 1998, there was a property overhang in the country totalling a staggering RM80 billion (Business Times, 1998), and these banks were in precarious positions, because most of their portfolios were tied-up with those unsold assets. As a result, the banking industry incurred a pre-tax loss of RM2.3 billion for the year 1997 (Star, 1999e).

Contrary to what may be thought about the lending activities of these banks, their lending policies are to a greater extent influenced by the regulatory requirements imposed by the authorities. Under the Banking & Financial Institutions Act (1989), the commercial banks are required to observe a risk-weighted capital ratio, a measurement based on the Basle capital framework which weights both on and off-balance sheet items according to their perceived level of risk. In addition, the commercial banks must maintain a certain proportion of their eligible liabilities as a statutory reserve. This reserve is a very powerful instrument of monetary policy, because it affects not only the capacity of a bank to extend credit, but also the cost of its funds since no interest is paid on them by the central bank. A higher reserve ratio would effectively 'lock in' a large proportion of the resources of the banks, and thus limit their ability to lend out such funds, while a lower ratio would raise the volume of resources available to generate new loans and advances.

On top of that, commercial banks are required to maintain a minimum level of liquid assets against their eligible liabilities. Unlike the statutory reserve, these funds are mobilised in the banks themselves, and they do yield a return, though not necessarily the highest rate in the market. The minimum liquidity requirement is designed not only to protect depositors, but also as a means of influencing credit situations. It acts as a device to ensure that banks play a direct and important role in financing the government's development efforts. By increasing the minimum requirements, the central bank would be able to channel more resources into specified assets, so that there would be less available credit in the banking system.

The interest rates on bank loans charged to the borrowers is determined by a market-oriented base lending rate or BLR. It is the minimum rate at which the banks will lend to their best customers. Commercial banks are allowed to quote their own BLR, but it must be based on a certain standardised formula set by the central bank from time to time, so as to ensure objectivity and comparability. The formula may incorporate the following factors (BNM, 1994): (a) funding cost, (b) administrative cost, that is, staff cost and overheads relating to lending activities (but excluding the cost of bad and doubtful debts), and (c) profit margin of 0.25 percentage point. To safeguard customer interest, the central bank fixed the maximum interest margin at certain percentage points above the BLR. The maximum penalty rate on any loan instalment in default is also fixed. Thus, the commercial banks are in no position to simply charge any types of customers, exorbitant rates.

Currently, there are 36 major commercial banks operating in the country, with a total branch network of 1671 (BNM, 1998). Out of this total, 13 are foreign-owned and controlled banks. In 1994, the central bank introduced a two-tier regulatory system which classifies banks into two categories, namely Tier I and Tier II. The aim of this system is to promote a more dynamic and innovative banking industry so as to respond to the changing requirements of the economy for sophisticated financial products and services. Tier I banks are selected based on their capital strength of not less than RM500 million in unimpaired shareholders' funds, which is to be raised to at least RM1 billion by the year 2000.

A total of 10 banks, including four foreign-owned, have achieved this Tier I status. These banks have satisfied a stringent set of criteria under the central bank's CAMEL framework which evaluated five critical components of banking operations, namely Capital adequacy, Asset liquidity, Management efficiency, Earnings performance, and Liquidity position. These banks are also allowed to conduct certain aspects of their operations under a more liberalised environment, such as operating foreign currency accounts for purposes of maintaining export proceeds in foreign currency, and the rationalisation of group operations and conduct of cross-institutional businesses within eligible banking groups.

Arguably, the Malaysian banking industry is still in a most difficult period. The slow economic recovery is painful. More effort has been spent in recovering loans, foreclosing on properties, and rescheduling loans for salvageable projects. It is still struggling to emerge from the aftermath of the crisis, while strengthening itself to meet the challenges that are diverse to the industry. There is now a move by the government to consolidate the country's commercial banks into a core of ten large banks in a rationalisation process through mergers and acquisitions of major domestic banks. It is believed that the changing financial environment, together with the changing role of technology, necessitated the need for change in the ways Malaysian banks were operating.

The pathology of the economic crisis is constraining loan growth, and the demand is expected to remain sluggish until such time as the economy fully recovers. The excess liquidity in the banking industry suggests that it would be unable to find big loans for customers. Therefore, there is a need for these banks to refocus more into non-traditional markets and other areas that the banks sometimes took lightly, such as the small business sector. However, such a move should also stress the importance of making the right decisions, and this in turn means knowing the facts and understanding what the market might mean.

2.5.3 Lending to Small Businesses

The most common form of bank financing used by small businesses is the overdraft. It is a facility where a bank allows the customer to overdraw his or her account up to an amount agreed upon. The customer draws down only parts of the line of credit as the need arises, so that redundant borrowings are unnecessary. This facility is normally given to finance the working capital requirements of a business, such as holding of stocks, extension of credit to buyers, and for operating expenses. Interest is charged on the amount overdrawn, and for the period of its use. The advance may be repaid as inflows of cash to the business occur. Cressy (1992) cites a number of reasons for the use of overdraft as a major form of bank financing. First, it is flexible and overcomes the need to extend a series of separate short-term loans. Second, it allows the customer some insurance against subsequent deteriorating in his or her credit rating. Finally, it can help in overcoming the moral hazard commonly associated with lending under asymmetric information.

Financing of small businesses can also be made available through term loans. These are generally medium to long-term loan facilities used largely for the purchase of major assets or for permanent increases in working capital. The maturity can be as long as 10 years, and thus these loans can expose the banks to potential default risks over a long period. Typically, these loans are amortised by periodic instalment payments. These payments can be on a monthly, quarterly, half-yearly or yearly basis, depending on the purpose for which the loans are given, the repayment ability of the business borrowers, and the total repayment period of the loans. This form of financing is, however, generally provided by the commercial banks against landed property.

As stated earlier, the commercial banks' policies are determined to a certain extent by the regulatory framework imposed by the authorities. Among the requirements is the special attention to be given to the small business sector. Since the early-1970s, the small businesses have been accorded a 'priority sector' status by the central bank for loans by the commercial banks. In a 1979 guideline, the commercial banks were required to channel at least 20 per cent of their outstanding loans in the form of loans to the small business sector.

In 1972, the Credit Guarantee Corporation (CGC) was established. Its main objective is to assist small borrowers in obtaining credit facilities from commercial banks at reasonable terms and costs. The CGC provides guarantee cover for commercial loans, for loans and advances extended to eligible small business borrowers. Generally, the CGC reimburses up to a certain amount of loss on loans, subject to a maximum amount depending on the nature and purpose of the facility granted, term of the loan, and repayment programme. Thus, most of the loans granted to the small business sector can be covered by the CGC.

However, the establishment of the CGC did not generate enough enthusiasm among the banks to assist the small business sector. As pointed out by its then chairman (CGC, 1973):

"The actual results were far below even our modest expectation...because they point clearly to a lack of willingness on the part of most lending institutions to give wholehearted support to the scheme".

Thus it became necessary for the government to take drastic action to compel commercial banks to increase their lending to the small business sector. In the earlier period of establishment, the General Guarantee Scheme (GGS) was introduced, where the CGC provided guarantees to commercial banks for credit extended to small-scale enterprises (SSEs) in the agriculture, industrial and commercial sectors for financing their capital and operational requirements. The maximum amount of loan was fixed at RM200,000 to the Bumiputera community, and RM100,000 to non-Bumiputeras. Most of these small-scale enterprises were engaged in producing mostly finished goods, such as foodstuffs, furniture, handicrafts, fabricated metal products, wood-based products, textiles and clothing (UNIDO, 1990).

In 1981, another scheme known as the Special Loan Scheme (SLS) was introduced, to provide a loan of up to RM50,000 without security. However, if these loans were used to finance the purchase of fixed assets or other assets, the small borrowers would be required to pledge them as collateral. Under this Scheme, the CGC provided a guarantee to commercial banks of up to 60 per cent, in return for a guaranteed fee of 0.5 per cent per annum on the value of loan approved. In 1989, the GGS and SLS were revamped into a single scheme with better features for both lenders and borrowers, known as the Principal Guarantee Scheme (PGS). The Scheme was again revised and replaced by the New Principal Guarantee Scheme (NPGS) in 1994.

The government had also introduced a special scheme in 1986 to meet the credit needs of micro-businesses. This scheme, known as the Hawkers and Petty Traders Loan Scheme (HPTLS), was to benefit hawkers and petty traders in the country. The loan ceiling was RM3000, but in exceptional cases went up to RM5000. In 1990, another scheme, the Association Special Loan Scheme (ASLS) was set up. The objective of the ASLS was to enable the hawkers' and petty traders' association to play a more direct and effective role in helping their members to secure loans, either to commence new businesses or expand their existing ones. The Scheme was also intended to expose the trade associations to the workings of basic lending functions. The ASLS was funded from a RM20 million soft loan provided by the central bank. These two schemes, HPTLS and ASLS, were later revised in 1990, and again in 1992.

The vigorous efforts made in the last two and a half decades to make available bank credit to the small business sector have achieved notable results. Taking the most recent data, CGC loans issued to small borrowers increased from RM205.8 million in 1993 to RM3,847.4 million in 1997, or by 1869.5 per cent. The bank lending under the CGC is shown in Table 2.3 below.

Table 2.3 Bank Lending under CGC Scheme (in RM millions)

	1993	1994	1995	1996	1997
General business	175.6	450.1	1,321.0	2,765.7	3,052.6
Small-scale industries	26.8	94.4	409.2	765.3	744.9
Agriculture	3.3	6.9	28.2	38.9	44.1
Mining & Quarrying	0.1	0.0	0.3	8.9	5.8
Total	205.8	551.4	1,758.7	3,578.8	3,847.4

Source: Bank Negara Report (1997)

The figures show a sharp increase in the loans approved under the CGC schemes in 1995 from previous years. This sharp gain was mainly due to an expansion of the CGC's role to include meeting the financing needs of the medium-sized enterprises and industries, thus allowing more borrowers to qualify for the schemes. Most of these businesses are active in the processing of beverages and tobacco, electrical and electronics products, chemical products, and non-metallic mineral products, and the production of automotive components and parts (UNIDO, 1990). In terms of percentage, there was a slight decline in 1996 as compared to 1995, but it dropped sharply in 1997. This was due to a drastic measure imposed by the central bank to counter the effect of economic and financial turmoil facing the country and other East Asian countries. These measures included slowing down credit growth in the banking sector, and channelling the available resources only to certain productive sectors recognised by the authorities.

Table 2.4 below compares the CGC loans to the total commercial bank loans for the years 1995, 1996 and 1997.

Table 2.4 Commercial Bank Lending and the CGC Loans (in millions)

	1995	1996	1997
CGC Loans	RM1758.7	RM3578.8	RM3847.4
Total Loans	RM182,078.7	RM228,256.3	RM289,746.3

Source: Bank Negara Report (1997)

The above figures show that loans approved under the CGC schemes are proportionately low compared to the total amount of bank loans channelled to all sectors of the economy. In 1995, they were only 0.9 per cent of the total loans approved, and for the years 1996 and 1997, the CGC loans constituted only 1.57 per cent and 1.32 per cent, respectively. The main reason given for the lack of CGC loans, despite the directive from the central bank, is the unwillingness of the commercial banks to participate in the guarantee schemes. These banks claimed that returns are much lower than those of ordinary loans, although they have to assume full risk on the funds disbursed (Abdul Latiff & Shanmungan, 1990; The Star, 1998). On top of that, they have to employ more manpower hours to manage the loans, most of which were small in amounts.

There seems to be a considerable government pressure upon the commercial banks to provide easily available and practical financial support to the small business sector. Many loan schemes and other structured financial packages have emerged. However, some results are still far from satisfactory. For example, the SMI Fund launched on January 1998 to provide credit facilities to SMIs in the manufacturing, agriculture and services sectors that export products elicited poor response. Administered by Bank Negara the Fund offers a minimum loan of RM50,000 and a maximum loan of RM5 million per customer, at a maximum lending rate of 8.5 per cent per annum, and for a maximum tenure of seven years until December 2005. As at the end of January 1999, only RM331 million was disbursed to this sector, a mere 22.0 per cent (The Star, 1999a).

Another fund, the Rehabilitation Fund, meant to alleviate financial difficulties facing the SMIs, did not seem to reach the targeted groups. This Fund provides financial assistance to viable firms that face temporary cash flow problems and difficulties in servicing their existing bank loans. Only 6.6 per cent of the RM750 million allocated has so far been disbursed by the commercial banks (The Star, 1999b).

One of the arguments on the slow disbursement of these funds pointed out in the preceding chapter is the indifferent attitude of the bankers towards the small businesses. This sometimes leads to bias in assessment of the creditworthiness of small business customers. It is further aggravated by the cumbersome conditions attached to loan applications, and the inability of the bankers, especially at the branch levels, to understand the issue and see the beneficial relationship with small business customers. Furthermore, in an economic situation where business prospects are uncertain, these bankers may be more vigilant in approving loans, as the small businesses are always perceived as less resilient than larger firms.

2.6 SUMMARY AND CONCLUSION

This chapter has introduced Malaysia, its economic policies and development, and examined the contribution of the manufacturing sector as an engine of growth towards realisation of a developed economy status by the year 2020. The chapter has also focused on the role accorded to the small business sector, and the particular constraints that confront it. The recent economic crisis has seen increased attention given by the policy makers to the contribution of the small business sector, and its emergence in playing a more pivotal role in revitalising the economy.

This chapter has attempted to provide an overview of the funding aspects of small businesses, with an emphasis on the relationship with the commercial banks. It also sought to understand the 'finance gap', an issue commonly associated with small businesses. The discussion tends to confirm the existence of such a gap, and that the small businesses are facing difficulties in gaining access to bank funding. It is also a controversial and still unresolved issue in small business financing.

It would appear that complaints about the small businesses not getting their due share of commercial bank finance are well-founded, and that the banks have not been able to take care of the credit needs of small businesses. There is therefore a need for the commercial banks not only to acknowledge the small business sector as a potentially viable customer, but also to devise ways of increasing the required funding to the sector. There remains much to be learned about the bankers' decision-making on small business loan applications. As pointed out earlier in 2.4.3, there seems to be a lack of research on understanding the process of making lending decisions among the bankers. Perhaps undertaking a study on a banker's attitude, behaviour and perception when making decisions can lead to an increase in understanding of the manner in which funds are being channelled to the small business sector.

CHAPTER THREE

3. DECISION MAKING: OVERVIEW

3.1 INTRODUCTION

It has been mentioned in Chapter One that the main objective of this study is to understand the lending decision process of bankers when dealing with small businesses. In order to study the process, the literature on decision making will be reviewed. The main emphasis will be on areas most immediately germane to understanding the decision behaviour. Although the scope of study is known to be very wide, the discussion on this chapter will only consider certain aspects of it. It is hoped that this basic knowledge will enhance appreciation of the later chapters that cover the decision-making of bank managers, as well as recognising several practical issues that need to be addressed when dealing with bank decisions on lending to small businesses.

The chapter begins with a focus on the definitions of decision-making and the forces that influence and shape the individual and organisation making crucial decisions. The chapter will then proceed to identify various models used in understanding the decision-making process, examine theories on rationality in human behaviour, and the essentials of heuristic or intuitive judgements. It also highlights the employment of quantitative tools in decision-making. The scope of discussions will be used to gain an understanding of the breadth and depth of the issue under study.

3.2 WHAT IS DECISION-MAKING?

According to Shull, Delbecq & Cummings (1970), decision-making is a conscious and human process, involving both individual and social phenomena, based upon factual and value premises. The process includes a choice of one behavioural activity from among one or more alternatives, with the intention of moving towards some desired state of affairs. Daft (1997) defines decision-making as a process of identifying problems and opportunities, and then resolving them. It involves effort both before and after the actual choice. Similarly, Kreitner (1995), Ofstad (1961) and Massie (1971) see it as a process of identifying and choosing alternatives course of action in a manner appropriate to the demands of the situation. These alternative courses of action must be weighed and weeded out.

Meanwhile, Harrison (1981) describes decision-making as a moment, in an ongoing process of evaluating alternatives related to a goal, at which the expectations of the decision maker with regard to a particular course of action impel him to make a selection or commitment towards which he will direct his intellect and energies for the purpose of attaining his objective.

Judging from the above definitions, it is clear that decision-making involves a choice, mental processes at the conscious level (although emotional or subconscious factors may influence the process), and a decision is made to facilitate the attainment of some objectives or results.

The scope of decision-making is wide. It can occur at the individual level, where it usually relates to the solution of problems such as personal, employment and social, or at the level of an organisation, where it is often expressed through basic managerial functions such as planning, organising, staffing, directing and controlling (Koontz, 1992). Decisions made by individuals affect only their own actions, while decisions made at organisational level will influence the actions of others (Massie, 1971).

At the individual level, a person is motivated by a hierarchy of needs, which range from physiological needs such as food, water and shelter to the need for self-actualisation (Maslow, 1970). However, self-actualisation may take on many forms, and be pursued with varying degrees of intensity. All these contribute to the way an individual makes a decision. Harrison (1981) argues that the decision-making in individuals tends to employ simple strategies, even in the presence of complex problems. The purpose is to obtain desirable solutions, which are frequently constrained by imperfect information, time and cost factors, severe cognitive limitations, and also manifold psychological forces.

Harrison (1981) further argues that, at the organisational level, decision-making is characterised by an extensive use of programmed decisions, which involve reasonably well-structured patterns of search. The more complex and significant the decision, the more extensive the search process will be. The decisions made are often bounded and biased by 'rationality'. In a situation where there are constraints and uncertainties, the organisation is likely to make decisions that are optimal in its spheres. Furthermore, the choice of decision rules and decision strategies is constrained by the desire to minimise these uncertainties.

Generally, the process of making a decision involves carrying out certain steps in a particular order. These steps should consist of the following elements: diagnosing the problem that necessitates a decision, identifying the criteria or attributes relevant to the solution of the problem, and evaluating, choosing and implementing the feasible alternatives.

The first stage of decision-making begins when the requirement is recognised in the form of either a problem or an opportunity. A problem occurs when some aspect of organisational performance is less than satisfactory. An opportunity exists when there is a possibility of enhancing performance beyond specified current goals. The awareness of this problem or opportunity requires surveillance of the environment for the issues that merit attention. However, it need not necessarily be founded on hard evidence, but may be based on little more than intuition, a general feeling that all is not well (Cooke, Slack & Cooper, 1984).

Once the problem or opportunity has been recognised, the next stage is to diagnose and analyse the underlying causal factors associated with the decision situation. These causes must be explored more deeply before considering further action. Eventually, it is now necessary to generate possible alternative solutions that will respond to the needs of the situation and correct the underlying causes. Some feasible alternatives may be identifiable, and others may be developed under high uncertainty conditions.

The selection of the most feasible alternative is the next stage. The best alternative is usually the one in which the solution best fits the overall goals and values of the organisation, and achieves the desired results using the fewest resources. Once the alternative is chosen, the next course of action is the implementation stage. The ultimate success of the chosen alternative depends on whether it can be translated into action. This requires the use of managerial skills and persuasive abilities to ensure that the decision is carried out.

The last stage is the evaluation and feedback. Evaluation is necessary to see how well the decision has been implemented, and whether it is effective in achieving its goals. Feedback is important because decision-making is a continuous, never-ending process. With the information gathered, feedback can precipitate a new decision cycle.

It is also argued that the process of decision-making just presented should be based on the assumptions that it is made in a 'rational' manner (Bazerman, 1998). The decision-maker here has clear, unconflicting objectives and a perfect knowledge of the problem. All information is gathered and all possible solutions considered. Far from being based on 'rational' ground, most decisions however, are often influenced by a mixture of emotions, power politics and the individual's own values (Adair, 1985). The decision-maker also lacks important information on the definition of the problem, while time and cost constraints limit the quantity and quality of available information (Simon, 1957). Furthermore, the decision-maker retains only a relatively small amount of information in its usable memory (Bazerman, 1998). Thus, these limitations may keep a decision-maker from a making a decision in a 'rational' manner. The issue of 'rationality' will be discussed further in the later section of this chapter.

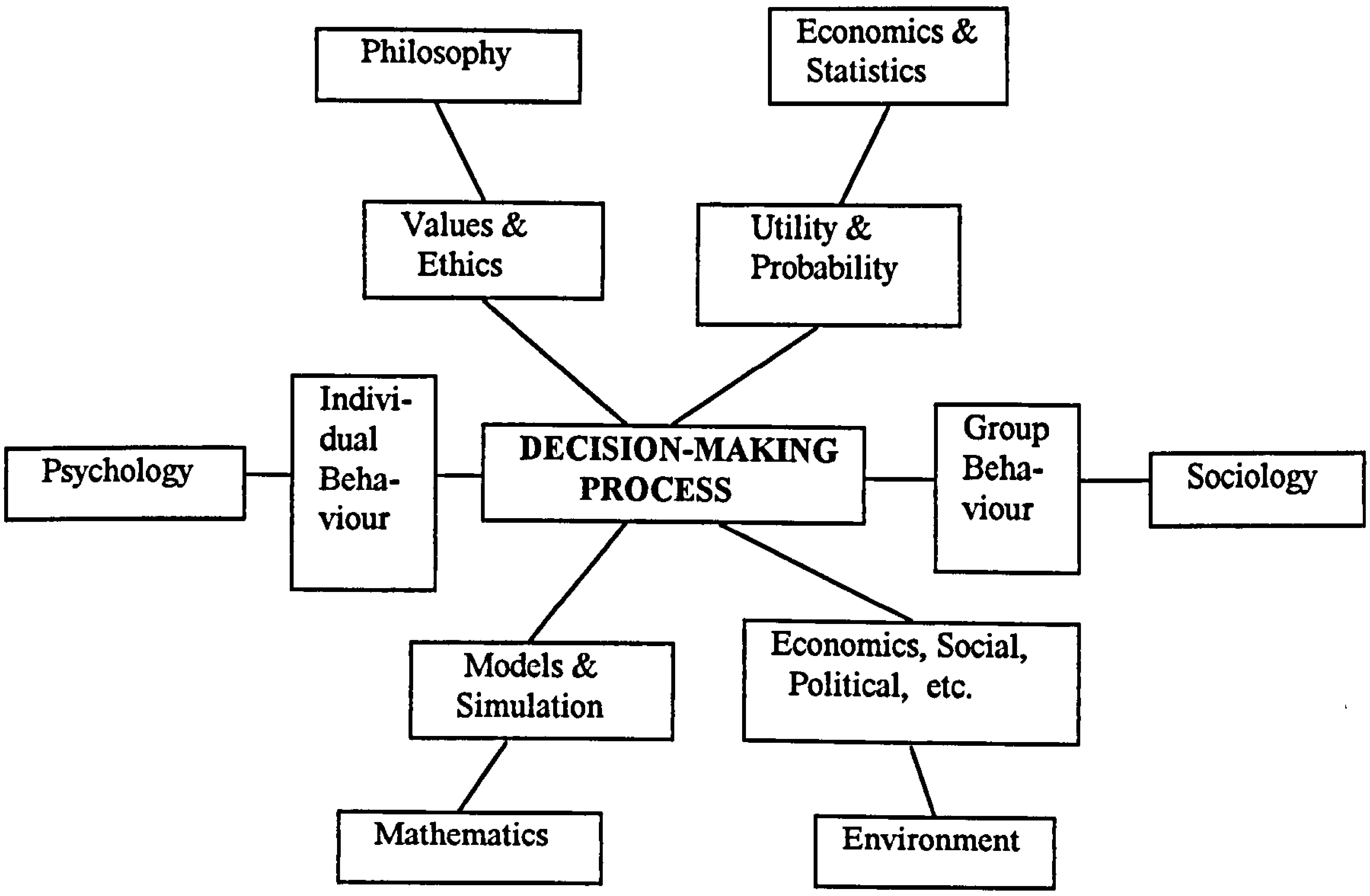
3.3 WHAT INFLUENCES DECISION-MAKING ?

Kreitner (1997) argues that the process of making a decision is complex and full of uncertainties, and that the degree of uncertainty varies from situation to situation. He identifies seven intertwined factors that contribute to the decision complexity. They include multiple criteria, intangibles, risk and uncertainty, long-term implications, interdisciplinary input, pooled decision-making, and value judgements.

Harrison (1981) concurs that the process of decision-making is not a fixed procedure or choice made at a particular point of time, but is integrated and dynamic, and influenced by a variety of disciplines. He argues that most views of decision-making tend to focus on only one or two disciplines, thus inhibits a complete understanding of decision-making as a process and results in a view centred largely on the decision-maker itself.

The surrounding factors that influence the process of making decision are depicted in Figure 3.1 below.

Figure 3.1 Factors Influencing Decision-making



Source: Harrison (1981)

1. Philosophy

The two philosophical areas that may influence a person in making decisions are values and ethics. A value is a fundamental and enduring belief of an individual about the most desirable condition and purpose of life (Frederick et al, 1992). It is an intrinsic part of an individual's life and thought, and it shapes his or her thinking and behaviour (Kreitner, 1995). The individual acquires values early in life and retains them throughout his or her existence.

Values are actually part of an individual's personality, and they provide a kind of guidance in the process of making a decision. An individual's values and those of an organisation exert a pervasive influence on the integrated process of organisational decision making. The values of an individual normally become fused with the values implicit in the organisation, but sometimes, they may conflict with the latter values. In such cases, this individual will usually accommodate his or her values to the purpose of the organisation.

Ethics is a conception of right and wrong conduct (Frederick et al, 1992). It can denote the application of values to the decision-making process. A standard decision usually results from a process that has been affected with the ethical interest. Both values and ethics are part of an individual, and they are reflected in his or her behaviour in arriving at a decision.

2. Psychology

The decision making is also affected by an individual's personality and perceptions of people, roles and organisation, as well as his or her values and emotions. Personality is said to encompass the characteristic traits and patterns of adjustment of an individual in his or her interrelationships with others and his or her environment (Kolasa, 1969; Lindgren & Harvey, 1981; Bernstein et al, 1997). Roediger et al (1991) look personality as both common elements of human nature and individual differences, while McGuire (1964) sees it as a holistic concept which is all-inclusive of those integrated qualities, impulses, habits, interests, ideals and other characteristics that compose the individual as he exists in society. Holland (1968) agrees that personality has an influence in the decision making process. He states:

"Effectiveness in decision-making is directly related to the effectiveness of the executive personality. The successful personality makes decisions freely without the compelling forces of hidden personality factors. Thus, the successful decision maker knows how to prevent his own errors and works on himself to improve his decisions".

Perception is another psychological force that can exert a significant influence on the decision-making process. Perception is defined as the process through which people actively use knowledge and understanding of the world to interpret sensations as meaningful experiences (Hayes, 1994; Bernstein et al, 1997). The willingness or disinclination of a given choice is influenced considerably by the individual's perception of the variables in the situation. Perceptions are also influenced by the expectations people have of a person enacting a particular role. An individual's perception is also influenced by where he stands as he looks at a situation, a fact or an act (Litterer, 1965; Roediger et al, 1991). Thus, differences in perception are likely to cause the reality of the decision situation to be viewed in different ways by different individuals.

3. Sociology

The decision-making of an individual is also subject to sociological forces of a group that he or she is a member of. These forces shape an individual's behaviour, beliefs and identity, and direct him or her to the making of a unilateral choice (Giddens, 1997; Fulcher & Scott, 1999). As a member of a group, it is necessary for an individual to subscribe to a certain pattern of behaviour so that cohesiveness is obtained with a minimum of dissension and conflict. Often individuals may find it difficult to compromise their aspirations and to accept a group choice that falls short of their expectations. On the other hand, there are some who may move easily into a group decision-making situation and experience little personal strain or frustration.

4. Economics and Statistics

The foundation of economics and statistics in the decision-making process is related to the concept of utility, where an individual continually seeks to maximise some objectives through the application of probability techniques (Carsberg, 1975; Wisniewski, 1994). This is based on the amount and type of information available to him or her. If there is limited knowledge or insufficient information of likely outcomes, this individual may assume some risks by assigning some subjective probabilities to the situations. However, the individual's position is made worse if he or she has little or no information at all on the likely outcome of his or her choice. This degree of uncertainty may require an estimate or a guess at the probability that should be assigned to the situation.

5. Mathematics

The discipline of mathematics appears in the decision-making process primarily through the development of models and their use to simulate real life situations. A model, according to Marx (1972), is any conceptual analogue, generally of a physical or mathematical nature, which is used to suggest empirical research. It is an attempt at representing some segment of reality and explaining, in a simplified manner, the way that segment operates. In order to develop a mathematical model, all the variables, their weights and causal connections, must be measurable and expressed in quantitative form (Jones, 1962). Models are used to describe, explain and predict the behaviour of selected phenomena through simulating the reality. Since reality is too complex, and/or sometimes irrelevant to the search for choices, models can be useful in contributing to the decision process by providing an abstraction of that reality. The application of mathematical models in decision-making will be examined further in the later section of this chapter.

6. Environment

No organisation exists in isolation. It operates in a real world of change, and is subject to the influence of the economic, political, social and technological forces that have impact upon it (Bain, 1995). The economic factor that could influence the decision-making includes employees, customers, competitors and the operations of government in regulating business activities and in using monetary and fiscal policies to influence the availability of credit and money supply. The political system is also a major determinant in the environment of decision-making. The influence of the government is felt mainly in the form of laws and regulations. However, there are also various interest groups that the decision-maker must contend with. Another of the environmental forces that exert a significant influence on the decision-making is the social system. It is a system of the actions of individuals, the principal units of which are roles and constellations of roles (Parsons & Shils, 1957). Since there will be value conflicts and role conflicts among the different parts of the society, the decision-maker should seek to identify the social conditions with which he or she must deal in the future. Finally, the final decision cannot be implemented successfully without considering the impact of technology. Since technology is the most dynamic of all the environmental forces affecting the decision-making, there is a need for the decision-maker to be constantly aware of its advances and the need to adapt to inevitable change. The more complex the technology, the more dynamic the environment within which the decision-maker must operate.

In banking business, the decision-makers must not only contend with the variety of disciplines that influence the decisions, but are also constantly alert to the environment because it is constantly changing. The critical factors that are normally associated with the environment include technological change, deregulation, interest rate risk and customer (Sinkey, 1998). Banks must pay attention to their environment because it is the source of both the resources they need to run the business and their profit. Particular attention is given to the increasing competition and the improving level of financial awareness and sophistication of the customers. Therefore, the environmental factors will have an impact too on the approaches of bank's decision-making, and its success depends on identifying and reacting to these changes.

3.4 APPROACH TO DECISION-MAKING

This section discusses the approach or style normally adopted by managers when making decisions in the organisation. Discussion on this issue is important because bankers, like other managers, may take similar approach when making decisions on lending.

McKenney & Keen (1974) were among the first to provide considerable evidence supporting the theory that managers use different styles when they make decisions. They identify two distinct styles of decision-makers. The first style is 'systematic', one which is more logical, orderly and analytical, and the second is more heuristic, trial and error-prone and haphazard. The latter decision-maker simply gropes along, using intuition, from one clue to the next until a pattern emerges which seems to indicate a solution. Daft (1997), on the other hand, classifies the approach to decision-making in the organisation into two models, namely the classical and the administrative.

The classical model is based on economic assumptions, whereby decisions are made on economic sensibility and in the best economic interest of the organisation. The assumptions underlying this model are:

1. The decision-maker operates to accomplish goals that are known and agreed upon. Problems are precisely formulated and defined.

2. The decision-maker strives for conditions of certainty, gathering complete information. All alternatives and potential results of each are calculated.

3. Criteria for evaluating alternatives are known. The decision-maker selects the alternative that will maximise the economic returns to the organisation.

4. The decision-maker is rational and uses logic to assign values, order preferences, evaluate alternatives and make the decision that will maximise the attainment of organisational goals.

Daft (1997) considers the classical model to be normative, because it defines how decisions should be made, besides providing guidelines for achieving ideal results. However, it does not describe how actual decisions are made. The value of this model has been its ability to help in a more rational decision-making. This classical approach has been given wider application because of the use of quantitative decision techniques such as decision trees, break-even analysis, linear programming, forecasting and operation research methods.

The administrative model, on the other hand, focuses on organisational factors that influence individual decisions. The assumptions are:

1. Decision goals are often more vague, conflicting and lack consensus. Decision-makers are often unaware of problems or opportunities that exist in the organisation.

2. Rational procedures are not always used, and when they are, they are confined to a simplistic view of the problem that does not capture the complexity of real events.

3. Most decision-makers settle for a satisficing rather than a maximising solution. This partly because they have limited information and partly because they have only vague criteria for what constitutes a maximising solution.

Daft (1997) considers the administrative model as descriptive, because it describes the actual decision-makings in complex situations rather than dictating how they should be made.

3.5 RATIONALITY IN DECISION MAKING

Discussion of decision making is not complete without referring to the issues of rationality in human behaviour (Eisner & van der Pligh, 1988). The concept of rationality in the decision-making process simply involves the evaluation and selection of some relevant alternatives based upon a perceived advantage accruing to the decision making (Harrison, 1981). It may or may not be attained, but what is important is that it be perceived and sought by the decision-maker. Simon (1997) refers it to the selection of preferred behaviour alternatives in terms of some system of values whereby the consequences of behaviour can be evaluated.

Robbins and Coulter (1996) insist that a decision-maker who is perfectly rational would be fully objective and logical. He or she would define a problem carefully, and would have a clear and specific goal. Furthermore, this rationality in decision making must be based on the following assumptions:

1. The problem is clear and unambiguous. The decision-maker is assumed to have complete information regarding the decision situation.

2. The decision has a single, well-defined goal that the decision-maker is trying to achieve, and there is no conflict over the goal.

3. The decision-maker can identify relevant criteria, lists all the viable alternatives, and is aware of all the possible consequences of each alternative.

4. The decision-maker can obtain full information about the criteria and alternatives because it is assumed that there are no time or cost constraints.

5. The rational decision-maker always chooses the alternative that will yield the maximum economic payoff.

However, in practice complete rationality can seldom be achieved (Simon, 1957, 1997; Koontz & O'Donnell, 1972; Harrison, 1981; March, 1994; Robbins & Coulter, 1996; Daft, 1997). Koontz & O'Donnell (1972) argue that rationality in decision making is unachievable, because decisions invariably involve uncertainty, all the alternatives that might be followed to reach the goal can hardly be recognised, and alternatives cannot be analysed in most instances, even with the latest available management analytical tools.

March (1994) suggests that not all alternatives are known, that not all consequences are considered, and that not all preferences are evoked at the same time. Furthermore, decision-makers are constrained by limited cognitive capabilities and complete information, and thus their actions may be less than completely rational in spite of their best intentions and efforts. Robbins and Coulter (1996) contend that an individual's information-processing capacity is limited. There are also time and cost constraints on decision-makers, which in turn limit the amount of search that can be undertaken.

Harrison (1981) concurs that an individual's decision-making is limited by a number of constraints. These are:

1. The intellectual capacity for dealing with only a few of the many complex variables bearing on the decision.

2. The amount of money and time that can be spent in the quest for relevant alternatives and the comparison, evaluation and eventual choice of the most desirable alternative.

3. The virtual impossibility of obtaining anything close to perfection even if one had limitless money and time.

Simon (1957, 1997) insists that the decision-maker is rational, but only up to a point. He or she does not necessarily want to find a solution to the problem, but often chooses a course of action which is good enough in view of the intended goal or the current level of aspiration ascertained. However, Simon (1957) also argues that the process of arriving at this course of action is bounded by several limits within which he or she must search for an alternative whose outcome will meet his or her aspiration level or objective. Simon labelled this state of affairs 'bounded rationality'. He states:

"The capacity of the human mind for formulating and solving complex problems is very small compared with the size of the problems whose solution is required for objectively rational behaviour in the real world, or even for a reasonable approximation of such rationality".

Simon points out that these limitations require the individual to construct simplified models of the real world in order to deal adequately with them. He or she will behave rationally with regard to the model that is certainly not optimal to the real world. Simon refers it as '*satisficing*', that is, picking a course of action that is satisfactory or '*good enough*' under the circumstances.

Simon (1985) further asserts that it is important to take into account the conflicting values that inevitably constrain even the most logical and dispassionate decision-maker. He maintains that these conflicting values within a culture, an organisation or an individual do significantly affect the decision and the result. Rather than abstract problems with one best solution, decisions are rooted in and shaped by the particular context perceived and understood by the decision-maker. Therefore, Simon believes it is impossible for human beings to analyse logically and dispassionately make the best possible decision.

3.6 INTUITIVE DECISIONS

In decision-making situations, individuals sometime cannot make their decisions on the basis of orderly rational analysis, and therefore they have to depend largely on intuitions. Intuition is often associated with having a hunch or a strong feeling of knowing what is going to happen. Often these hunches are vague, and since they are rarely recorded, they are seldom verifiable (Vaughan, 1989). However, intuitive or heuristic decision-making is not necessarily arbitrary or irrational, because it is based on years of experience that enable individuals to identify solutions quickly without going through an analytical process. Simon (1997) argues that, in most instances, decisions are usually too rapid to permit an orderly sequential analysis of the situations, and the decision-makers cannot usually give a valid account of either the process by which the decisions were reached or the grounds for judging them correct. Nevertheless, decision-makers may have great confidence in the correctness of their intuitive decisions and are likely to attribute their ability to make them rapidly to their experience. According to Simon:

"Intuitive judgement is simply an analysis frozen into habit and into the capacity for rapid response through recognition of familiar kinds of situation. Every manager needs to be able to analyse problems systematically (and with the aid of the modern arsenal of analytical tools provided by management science and artificial intelligence). Every manager needs also to be able to respond to situations rapidly, a skill that requires the cultivation of intuition and judgement over many years of experience and training. The effective manager does not have the luxury of choosing between analytic and intuitive approaches to problems. Behaving like a manager

means having command of the whole range of management skills and applying them whenever they become appropriate".

The importance of intuition in decision-making has also been acknowledged by the top management (Agor, 1989; Isenberg, 1989). These managers use intuition in at least five distinct ways. First, they sense intuitively when a problem exists. Second, managers rely on intuition to perform well-learned behaviour patterns rapidly. Third, they use intuition to synthesize isolated bits of data and experience into an integrated picture, often in an "*aha*" experience. Fourth, some managers use intuition as a check on the results of more rational analysis. Fifth, managers can use intuition to bypass in-depth analysis and move rapidly to come up with a plausible solution. Used in this way, intuition is an almost instantaneous cognitive process in which a manager recognises familiar patterns.

Argor (1989) also identified the following conditions under which the intuitive ability of these managers seems to function best: (a) when a high level of uncertainty exists, (b) when little previous precedent exists, (c) when variables are less scientifically predictable, (d) when "facts" are limited, (e) when facts do not clearly point the way to go, (f) when analytical data are of little use, (g) when several plausible alternative solutions exist to choose from, with good arguments for each, and (h) when time is limited and there is pressure to come up with the right decision.

However, it is argued that the use of intuitive or heuristic judgement can sometimes lead to serious and systematic errors (Kahneman, Slovic & Tversky, 1982). These errors are often referred to as "cognitive biases", because they result from an attempt to apply the normally useful heuristics to situations in which they are inappropriate. They are:

1. Availability Heuristics

Tversky & Kahneman (1973) argue that people have the tendency to judge the probability of an event by the ease with which relevant information about that event comes to mind. This is termed availability heuristics. Instances of frequent events are typically easier to recall than those of less frequent ones. However, recall is also influenced by factors unrelated to likelihood, such as imaginability, familiarity and vividness. Consequently, availability heuristics may result in systematic bias (Kahneman & Tversky, 1973).

Lichtenstein et al (1978) illustrated this point. In a study, they found that when people judged much-publicised deaths from certain causes, they overestimated those small frequencies, while they underestimated the relative frequency of less publicised ones. Meanwhile, Nisbett & Ross (1980) insist that increased availability of a mental item could be related to greater attention to the item when presented, more effective coding of the item into memory, more stable storage, or more effective retrieval. Similarly, Abelson & Levi (1985) found that the rehearsal of relevant event scenarios may also enhance availability of that specific scenario.

It is clear that the availability heuristics can bias judgement by giving easily imagined events more importance than their objective frequency warrants. When the events being estimated are likely to be rare, the availability heuristics can seriously impair fair judgement (Eisner & Plight, 1988).

2. Representativeness Heuristics

This form of heuristics is termed representativeness, to refer to the dominance of individuating information in intuitive prediction. Kahneman and Tversky (1972) found that there is tendency to judge the probability that a stimulus belongs to a particular class on the basis of how representative or 'typical' of that class it appears to be. On the other hand, there is little regard for the base rate probability of a stimulus belonging to that class. This judgement may lead to a decision with several cognitive errors such as insensitivity to prior probabilities, misconceptions about randomness, and misconceptions about conjunctive probabilities, that is, the probability of a joint occurrence of two or more events (Tversky & Kahneman, 1974).

Kahneman & Tversky (1973) assert that ignoring prior probabilities can lead to biased judgement. They gave an example where experimental subjects were provided with brief personality sketches of engineers and lawyers. Next, these subjects were asked to rate the probability that each sketch described a member of one profession or the other. Half the subjects were told the sample consisted of 30 engineers and 70 lawyers, the other half were told that there were 70 engineers and 30 lawyers. The findings were an impressive demonstration of the representativeness heuristics in operation. The prior probabilities (the numbers of engineers and lawyers) were essentially ignored. Instead, subjects assigned probabilities by judging how similar each personality sketch was to their stereotype of an engineer or a lawyer. Fischhoff

& Bar-Hillel (1984) also found that prior probabilities were ignored when case descriptions were highly stereotypical.

Representativeness heuristics can also be related to misconceptions about randomness and insensitivity to sample size. Kahneman & Tversky (1973) further argue that decision-makers who ignore sample size when making probability judgements are believing in the 'law of small numbers'. This law applies to the assumption that any sample, no matter how large, is an equally representative estimate of population parameters. This assumption contradicts the statistically valid law of large numbers, which states that the larger the sample, the more accurately it reflects population parameters (Emory & Cooper, 1991; Sekaran, 1992).

Another consequence of the representativeness heuristics concerns the perception of conjunctive probabilities. It has been suggested that people tend to overestimate the probability of a conjunction of events (Cohen, Chesnick & Haran, 1971). This conjunction bias refers to the tendency to see the joint occurrence of events A and B as more likely than event B alone.

3. Anchoring and Adjustment Heuristics

Tvesrky and Kahneman (1974) have also identified a heuristic called anchoring and adjustment. This heuristic can be related to individuals making estimates from a starting value that is adjusted to give a final answer. For example, individuals were asked to estimate various quantities, stated in percentage. Before they made their estimates, these individuals were shown an arbitrary starting value between 0 and 100 given by a spin of a wheel of fortune. The individuals were required to indicate whether they considered this value too high or too low and then to give their own estimate. Different groups of people were given different starting values. Surprisingly, these people used the starting point as an 'anchor' to their final estimates, although the starting point may be totally arbitrary or the adjustments crude and imprecise.

3.7 QUANTITATIVE TOOLS FOR DECISION MAKING

There is an array of quantitative tools frequently employed in the decision-making process. The use of quantitative techniques helps decision-makers to make choices under conditions of risk and uncertainty. In bank lending situations, decisions are often emphasised events that are yet to occur, and hence they must be made under varying degrees of uncertainty. Therefore, it will be appropriate, to discuss at the outset the nature of quantitative models, and how they can be used to aid decisions. This section examines the use of two of the techniques namely, decision tree and mathematical models.

1. Decision Trees

Decision tree analysis is one of the most widely-used decision analysis techniques (Ulvila & Brown, 1982). It can be used for any decision situation in which probabilities can be estimated and decisions occur in sequence.

The decision tree consists of a series of nodes and connecting lines, or branches (Harrison, 1981; Daft, 1997). Alternative courses of actions are represented by main branches, which in turn have subsidiary branches for related chance events that occur in chronological sequence. This tree diagrams the paths that lead to possible consequences. However, the decision-maker cannot choose which path to follow, and must wait until after the decision has been made to see which events occurred.

Decision trees can be of considerable assistance to decision-makers in achieving an overall picture of the decision-making situation (Harrison, 1981). This includes the possible action choices, the related risks, and the possible outcomes. Decision trees can also serve to clarify the decision criteria and the information needed for decision-making purposes.

2. Mathematical models

Mathematical models are often used to assist the decision-maker throughout the decision-making process. A mathematical model is a representation of some segment of the real world. Starr (1971) defines it as a simplified representation of reality, while Daft (1997) sees it as a representation of the relationships among variables in real-life organisational situations. Cohen and Hammer (1966) contend that a model eliminates the irrelevant and unimportant details of the real system, and instead concentrates on the fundamental elements, variables and relationships.

A mathematical model can be useful in most parts of the decision-making process, and it can contribute greatly to the search for alternatives (Harrison, 1981). It is mainly used in simulating real-world situations, and through its predictive capability, it can signal problems or difficulties in time to avoid full-scale commitment of resources to a particular course of action.

The effective use of quantitative techniques can aid greatly in managerial planning and decision making. The primary strengths of these techniques are their ability to enhance decision effectiveness in many situations, and in providing a systematic way of thinking about and organising complex problems. Furthermore, they help in simplifying the analysing of decision problems, choosing among alternative analyses, and determining ways of implementing the results of the analyses. Decision-makers need not rely on intuition to make a complicated, multidimensional decision.

However, the quantitative techniques are best suited to decisions characterised by uncertainty or risk where relevant information is available and probabilities can be calculated. But in practice, decision situations are often too ambiguous and subjective, and thus, these techniques may not be able to fit into them. Furthermore, the model used is only a simplification, and may not reflect the reality of the real situation. If some important elements or variables are left out in the construction of the model, the outcome will be unrealistic (Daft, 1997). In addition, the techniques are only good only when they are applied in the specific process, but not the entire decision-making process (Harrison, 1981).

According to Emory and Niland (1968):

"The contribution of quantitative techniques to decision-making is largely in the appraisal step, the analysis of decision possibilities. Quantitative techniques are unable to suggest hypotheses or to define problems or to suggest alternatives. These abilities remain in the domain of personality, experience and creativity. But once alternatives have been defined, these techniques can be powerful tools for making quick and accurate appraisals".

The theories surrounding the decision-making process suggest that decision-makers often overlook alternative choices or ignore vital information for critical decisions. However, given the complexity of the process, it may be costly or impossible to gather all the potentially relevant information, it may also be difficult to decide what information is relevant, and it may not be easy to combine information from different sources or of different kinds.

Furthermore, due to the 'bounded' nature of human rationality, people may use various strategies to enable them to handle complex decisions. These include simplified "problem representations" to handle the task with the available cognitive resources, and the use of intuitive judgement is a response to decision-demanding situations (Simon, 1985; Eisner & Pligh, 1988).

Nevertheless, Simon (1997) believes that most effective decision-making involves an intimate combination of intuition and analytic techniques. Every decision-maker needs to be able to analyse problems systematically (and with the aid of the modern arsenal of analytical tools), and he or she needs also to be able to respond to situations rapidly, a skill that requires the cultivation of intuition and judgement over many years of experience and training. However, he reiterates that effective decision-making does not rely exclusively on any of the two skills.

3.8 SUMMARY AND CONCLUSION

This chapter has examined a variety of theoretical and practical issues that arose in decision-making, whether by the individual or within an organisation. It provides an understanding of the critical elements in the decision making-process as well as offering a range of explanation on issues of rationality and irrationality of decision-makers' behaviour. The detailed discussion on the duality of approach employed by decision-makers should not inadvertently lead to the conclusion that decision-making is either inherently intuitive or analytical. Rather it should be understood that good decision-making should, ideally, involve an integration of these two modes in a complementary role to facilitate the attainment of desired goals.

The chapter also highlighted that decision-making is inherently a complex process, and that it is related to a high level of ambiguity and uncertainty. By examining this complexity, perhaps it can provide a better understanding on the main issue of this study, that is the bankers' decision-making on small business loan applications. Presently, inadequate attention has been given to understanding the bank's lending-decision process, although it is a major operational activity and crucial to the organisation's progress. Perhaps the major reason for this paucity is, simply, the fact that few decision-makers in the banks knew of the existence of decision complexities, or may even be unaware that any problem exists in their decision-making in the first place.

The era of rapid acceleration in the banking industry today brings about the challenges of dealing with complexity, uncertainty and risk, and a need for flexible thinking and decisions. Like many decision-making situations, the bank lending decisions may also consist of the process of identifying the problem, generating alternative solutions, selecting a solution, and implementing and evaluating the solution. Since theoretical inputs are crucial to many aspects of normative decisions, the researcher also believes that detailed theoretical knowledge is fundamental to improving decision-making in the banking context.

There is now a widespread appreciation by bankers of the need to understand the issues, so that they will be in a better position to respond to the problems effectively and efficiently. Therefore, understanding the theoretical issues and the forces that could influence an individual and an organisation in making a decision can provide crucial knowledge on the actual process of bank managers' decisions on lending to small businesses.

CHAPTER FOUR

4. BANK LENDING DECISIONS: THEORETICAL AND PRACTICAL CONSIDERATIONS

4.1 INTRODUCTION

In the preceding chapter, the relevance of a decision-making theory was examined in general terms. A number of theoretical issues and concepts, which are crucial in understanding the decision-making process, were also discussed. The chapter also examined the contribution of the behavioural and quantitative sciences in the understanding of how decisions are made or ought to be made.

The focus of this chapter will be on the decision-making of commercial banks with respect to loan provisions. The purpose is to provide a detailed review of existing empirical studies and also practices of commercial banks on lending decisions. In addition, this chapter will consider some of the key issues in the decision-making process to provide normative guidance on bank lending decisions on small businesses. A number of recently emerged theories that address the area of banking relationships will also be examined as frameworks within which the small business financing may be made. Although it is often argued that knowledge of banking theoretical literature plays a less critical role in the operations of a bank (Sinkey, 1998), theories are still interesting and important for generating insights about banking behaviour. Moreover, a clear understanding of the theoretical underpinnings adds to the knowledge of how the lending decision process works.

The chapter begins by considering a number of articles on bank lending to provide an insight into the lending decision process. This will be followed by a review of literature relating to the 'finance gap', a long-running issue commonly associated with the small businesses. The chapter will then proceed to develop insights into decisions on lending to small businesses, with a view to discovering how such decisions are made or ought to be made.

The literature to be examined in this chapter deals mainly with the banking system in the US and the UK, and some discussions may be of contrasting perspectives, due to two entirely different systems. However, the researcher believes that the fundamentals of banking are similar, irrespective of the country's banking system. As quoted from Sayers (1967):

"… … bankers think in much the same way the world over. They get into the same habits, they adopt the same attitudes to their customers, and they react in much the same way to changes in the economic climate. The principles of banking therefore have world wide validity, and what is said of English bankers and the working of the English system can often be said with almost equal truth of other countries".

Furthermore, the Malaysian banking system, the focus of this study, follows to a large extent the British banking system. And a considerable number of the bankers have been trained or educated either in the US or the UK. Thus, certain terms and concepts found relevant in the literature, such as credit and loan, or evaluation and assessment, may be used interchangeably to suit the objective of this study.

4.2 BANK LENDING DECISION: OVERVIEW

It is generally accepted that the fundamental aspect of a bank lending decision is the management of risk (Hutchinson & McKillop, 1992; Sinkey, 1998). The bank's objective is to achieve acceptable returns through an assessment of risks in respect of the borrower, but no investment will guarantee a given profit or return in the future. Some investments are more likely to produce positive returns, and therefore are less risky. On the other hand, other investments are less likely to generate positive returns, and therefore have more risk. The concept of risk-return trade-off applies here, where the banker may charge higher than average interest rates to riskier investments, and vice versa. Risk is associated with uncertainty, and it is reflected by unanticipated changes in events (Sinkey, 1998). For bankers, uncertainties that are commonly associated with lending decisions are credit risk, liquidity risk, and interest rate risk (Jilk, 1972; Rose, 1993; Heffernan, 1996).

Credit risk is the risk that a loan may become irrecoverable or that there may be delay in the repaying of interest and principal by the borrower. Because the bank's funds are composed of mostly deposits, and its own capital is relatively small, any bad loan will undermine the value of the bank's assets and it can be pushed to the brink of failure. The main indicators of credit risk are the non-performing loans (NPLs) and bad debts. NPLs are the loans that are past due for a certain stipulated period (in most cases 90 days or more), while the bad debts are loans that have been declared irrecoverable by the bank and written-off. The main purpose of assessment of a borrower's creditworthiness is to identify the credit risk factor associated with that borrower.

Liquidity risk is the risk of insufficient cash and borrowing capacity to meet deposit withdrawals, loan demands and other cash transactions. The banks need liquidity to meet these requirements. Customers usually place their deposits with a bank, confident they can withdraw them when they wish. However, these deposits are mainly used for lending purposes, and there is a possibility of their being tied up for a relatively longer period of time. Since deposit withdrawals and borrowing activities occur on a regular basis, the bank must also be prepared to meet these needs regularly. If unexpected deposit withdrawals and/or unexpected loan demands occur, the bank is vulnerable and a liquidity crisis could develop. Similarly, the interest rate movements can affect the bank's performance. Rising interest rates can lower a bank's profit margin if the structure of assets and liabilities is such that interest expenses on deposits and other borrowed money increase more rapidly than interest revenues on loans and investments. Nonetheless, when a bank experiences severe liquidity crisis or potential cash flow insolvency, the underlying cause can usually be traced to excessive credit risk, manifested by heavy loan losses.

Therefore, the major task of a bank lending decision is managing, controlling and accepting risk. Because the major risk banks face is credit risk, that is the uncertainty associated with borrower's loan repayment, it is imperative that bankers be able to estimate the borrower's probability of default. In practice, these bankers focus on the borrower's creditworthiness through its basic lending function which concentrates on the gathering, processing and analysing of timely and accurate information. However, the ways in which bankers examine the information regarding the prospective borrower are associated with differences in how they perceive the way the information is presented. Rosman & Bedard (1999) argue that due to the trading-off of anticipated costs and benefits of various ways of analysing information, bankers select a strategy based on both the cognitive effort involved in making the decision and its anticipated outcome quality. These bankers will trade-off decision process effort against the expected costs associated with adverse decision outcomes. Bankers who apply less effort in the loan decision may anticipate the possibility of a lower quality decision outcome. Thus they will select a loan structure giving increased protection against eventual loss from default. Conversely, bankers applying more effortful strategies will select less restrictive loan structures. Therefore, this implies that differences in lending decision are associated with the ways in which individual bankers analyse information.

To put the fundamental concept of bank lending decisions in perspective, a review of both empirical and practitioner literature will examine some of the tools, techniques and methods used by the bankers. Basically, the principles behind bank lending decisions are safety, suitability and profitability (Mather, 1979). Safety demands that the loan must be safe, and that it should only be granted to a reliable borrower who can repay from reasonably sure sources within a stipulated period. The safety requirement is sometimes supported by the deposit of approved security as an insurance against unforeseen circumstances. Suitability requires that the borrower, if possible, be completely free from all risks, while profitability means that granting loans and advances must generate profit, directly or indirectly, to the banker. These basic principles are essential in lending decisions by most bankers in accepting or rejecting loan propositions.

In the United States, the principles of lending consist of 5Cs, namely character, capacity, capital, collateral, and condition (Orgler, 1975; Haynes, 1993; Sinkey, 1998). Character is associated with ethical matters such as honesty, integrity, industry, trustworthiness and morality that are accepted by most people as being desirable attributes in a human being (Reed et al, 1984; Goldenberg, 1993). The assessment of character is the most difficult in terms of measurement and explanation. It is because each person has his or her own concept of character, and the judgement depends upon those who judge.

The character of a borrower is important in the lending decision, because it often determines his or her willingness and intention to repay the loan (Ruin, 1998b). It would be of no comfort to a banker if a borrower has the means to repay his or her debt, but has to be pressured or threatened with legal action to do so. The banker may assess a borrower's character based largely on the latter's past experience, market talk, his or her conduct during the interview, and his or her repayment records with other banks or creditors. It is argued that this assessment can reveal the borrower's responsibility, truthfulness, seriousness for requesting the loan, and seriousness to repay all debts (Rose, 1993). Successful bank lending is also attributed to identifying the good character of a borrower (Shanmugan & Turton, 1992). Dishonest borrowers do not feel morally committed to repay debts. Thus, a careful character assessment is important, because a determined and skilled borrower can easily get a loan by misrepresentation.

The second 'C' in the lending assessment is capacity. It is the ability of the borrower to repay the loan. Ascertaining a borrower's ability to repay takes a lot of time of the banker (Ruin, 1998b). It involves many factors, such as education, personal health, skills, age, stability of employment, and resourcefulness. Abdel-Khalik (1973) and Mansfield (1979) look to managerial quality, and that past performance reflects the quality of management, while Thorpe (1996) focuses on financial statement analysis. Barona (1985) contends that capacity depends on the characteristics of the borrower's future cash, which in turn depends on fundamental factors, such as the internal management, industry environment, and the general economic environment.

The main purpose of capacity assessment is to ascertain the creditworthiness of the borrower. The judgement of whether a borrower is creditworthy is based on the lender's assessment of a borrower's ability to repay the loan and to repay it within a certain time period (Kemp & Overstreet, 1990). This judgement is based on information the banker has at his or her disposal. In judging creditworthiness, Eisenriech (1981) has this to say:

"Since repayment always occurs in the future, the lender must judge whether the borrower's expectations about the capacity to repay are reasonable. Throughout the process, the lender's technical skills may be invaluable in asking the right questions. However, determining whether the answers are 'reasonable' requires judgement, often conditioned by time and experience".

Capital, the third 'C' in the lending assessment, is the financial backing or strength of the borrower. This strength is reflected in the equity or the net worth. The banker would feel more secure if the strength of the borrower is determined. The assessment of capital would determine how much a banker would get if the borrower's business is liquidated or he or she is made bankrupt. In this assessment, the banker would always insist that the borrower's ownership in the business is significant in relation to the loan requested (Dorfman, 1991). This is to ensure that the borrower with a significant stake in the business would be a prudent user of the loan money.

The fourth 'C', collateral, is obtained as a form of security or insurance against any unforeseen development, but it is supposed to be the last thing to consider in the lending assessment. If a banker is convinced that the borrower would not be able to repay the loan, the availability of collateral would not, under given circumstances, enable the banker to sanction or approve the loan application (Ruin, 1998b).

The last 'C' is the condition, which refers to the environment where the borrower's business is situated. The assessment would include all of those factors that affect the ability of the borrower to repay his or her loan, and sometimes are beyond the control of the borrower or of the banker. The focus is on the borrower's downside vulnerability (Sinkey, 1998). The banker may want to know to what extent changes in the regulatory, economic, political and technological conditions would affect the borrower's business, and whether this borrower would be able to cope with changes to any of these conditions.

The 5Cs are the norms of lending assessment among bankers or in any credit analysis in the United States. However, these 'Cs' should not be a panacea to lending decisions, rather they should serve as valuable reminders that the decision to accept or reject a loan application involves multifaceted and complex considerations (Jones, 1982). They should also be viewed as merely 'memory joggers' to the decision-makers, rather than a conceptual decision-making approach to loan selection (Mitchell, 1976).

Meanwhile, there are a number of writers who have contributed to the richness of the existing literature. White (1990), for example, adds two more 'Cs', that is, customer relationship and competition. Customer relationship is related to answering the 'will' and 'can' questions. The banker will have an existing relationship with the borrower, and additional information and experience to bring to the assessment. He or she must also always have in mind competition when making lending decisions. However, competition should best be used in a support role to the other 'C', rather than as a primary determinant in the decisions.

Cooper (1974) suggests the use of '4Ps' instead of 'Cs' in the lending assessment. These Ps stand for people, purpose, protection and payment. People, is the assessment of the borrower's character, while purpose involves a judgement as to the benefit of the borrower's product or service. Protection refers to the thorough examination of financial statements as well as obtaining security, and payment is the judgement about the future cash flows for the repayment of loan.

Golden & Walker (1993) come out with another '5Cs' as an alternative approach to lending assessment. Instead of looking only at the future outcome, they suggest that a banker must also learned from past mistakes. The 'Cs' of mistakes are complacency, carelessness, communication, contingencies, and competition. But they are to guard against bad credit and as lessons learned from past lending mistakes.

Complacency can be traced to the problems of over-reliance on guarantors or on large net worth, over-emphasis on past performance, forgetting the bad times or seeing only the good times. Carelessness is the second mistake, due to improper documentation, incomplete financial and inadequate loan covenants, while a communication breakdown, though a simple problem, can easily destroy the whole bank. Bankers sometimes fail to look at the contingencies and to explore the second or third ways out of loan deals available to borrowers and lenders. They are supposed to look at every bad thing that can happen, and then decide how likely it is that any of these things will in fact happen. Finally, competition is also the most important of the 'Cs' of bad credit. Bankers sometimes make decisions because of what other banks are doing, rather than concentrating on the merits of the borrowers. They decide to do whatever it takes to win business. Unfortunately, that means making credit standards as loose as or looser than everyone else.

In the United Kingdom, the bank loan assessment is normally guided by principles known as the canons of good lending. These principles, which are usually in the form of a mnemonic, provide a list of criteria for the process of making decisions. The most commonly used is CAMPARI, which stands for character, ability, margin, purpose, amount, repayment, and insurance (Rouse, 1989; Davies & Kearns, 1992; Berry, Crum & Waring, 1993).

Like the 'Cs' of analysis in the United States, the bankers here also assess character on honesty and integrity, besides the stability, resources and connections of the borrower. They are also concerned whether this borrower has the capacity to borrow, and the ability to manage the business and/or his or her financial affairs effectively. However, in contrast to the '5Cs', the CAMPARI framework is more specific with respect to purpose and terms of the loan.

The margin is the remuneration or returns a banker can expect from the type of borrowing requested. The greater the risk, the higher the interest rate will be charged. However, if the risk is too high for a banker to contemplate, the loan application may be totally rejected (Hutchinson & McKillop, 1992).

In the assessment, the prospective borrower must specify the purpose of the loan requested, and bankers are only willing to finance those purposes that meet the bank's criteria. The loan must not be used to fund any illegal, immoral or restrictive activities as imposed by the authorities. The assessment of the purpose of loan is of significant importance to the lending decision because it can identify the risk potential of the borrower (Berry et al, 1993b). In addition, the banker would need to verify the amount requested for the intended purpose of the loan, whether the amount is correct and justifiable or not, and the expected contribution from the borrower from his or her own funds.

It is also the ultimate loan objective that it is repaid, and hence the 'R' or repayment. The bank may assess the commitment on the borrower's present and future income, and identify whether or not the loan can be repaid without adding financial strain to the borrower.

Last but not least, the question of insurance or the taking of collateral. It is often used against unforeseen events that may adversely affect what would otherwise have been a good business proposition. However, as in the analysis of Cs, the collateral should be considered only as a safety net, and not as the prime point of consideration in the lending decision.

Another approach that applies to the lending assessment is in the mnemonic SCRAP, which refers to security, creditworthiness, repayment, amount and term, and purpose (Whiting, 1994). The assessment of creditworthiness focuses on a borrower's past history and/or making judicious enquiries. Whiting argues that banks are only willing to provide loans to those customers who are sufficiently creditworthy. He also points out that a banker is more concerned with the borrower's source of repayment than relying on security, and that security should only be taken as a last resort. However, if the borrower is prepared to lodge some security for the loan, the banker would be more likely to agree to it or to lend a larger sum than would otherwise be forthcoming.

4.2.1 Approach to Lending Decision

This section presents some of the approaches taken by bankers in the UK and the US in assessing loan applications. The focus of discussion is on the process of making a decision in the bank's lending context, while efforts are made to relate it to those theories of decision-making reviewed in the preceding chapter.

Berry et al (1993b) define the lending decision as a process that involves the gathering of information resulting in the formation of opinions about a prospective borrower, and his or her loan application. The information gathered could be factual, based on past experiences, or obtained during the interview with the borrower. The decision is derived from the opinion of the banker based upon his or her perception of the borrower. This opinion rests mainly on the judgement of the banker rather than on any tangible and verifiable information obtained about the borrower.

The two basic approaches to bank lending decisions are the 'going concern' approach and the 'gone concern' approach. The former seeks to assess the applicant's source of repayment, which is reflected ultimately in the ability to generate cash and profits in the future. Historical financial statements are normally taken into account in the assessment because they help to form views of future performance. The gone concern approach is also commonly known as 'liquidation approach', and is more interested in knowing the net value of the borrower's assets. These assets are adjusted to their forced sale value and then compared with the liabilities. The banker will only be satisfied that the loan can be repaid if the assets exceed the liabilities by a considerable margin (Barona, 1985).

Traditionally, banks in the UK adopted the gone concern approach in lending decisions (Berry et al, 1993b). Due of the nature of this approach, these banks tended to be more conservative in their lending policies, since they were not willing to lend a sum that exceeds the value of the borrower's assets. However, there is evidence that these banks have also embraced the going concern approach for most of their lending. This is clearly stated in an article in the Midland Bank Review (1981):

"Bank lending is going concern lending. Loans are made in the belief that the borrower will remain viable and be able to service and repay his debt out of income. The primary purpose of analysing a balance sheet is to see whether this belief is well founded, and a look at the gone concern position is a secondary aspect of the test. Indeed the gone concern test is not used at all when appraising many propositions and, at least in the Midland Bank, it has fallen into decline".

Berry et al (1993b) further emphasise that, in practice, the going concern approach is the most desirable from the borrower's perspective, but the adoption of either approach is not always clear. Some banks adopting the going concern approach may take secured lending, while banks using the gone concern approach may require forecast and trends. Thus, the difference between these two approaches can become blurred.

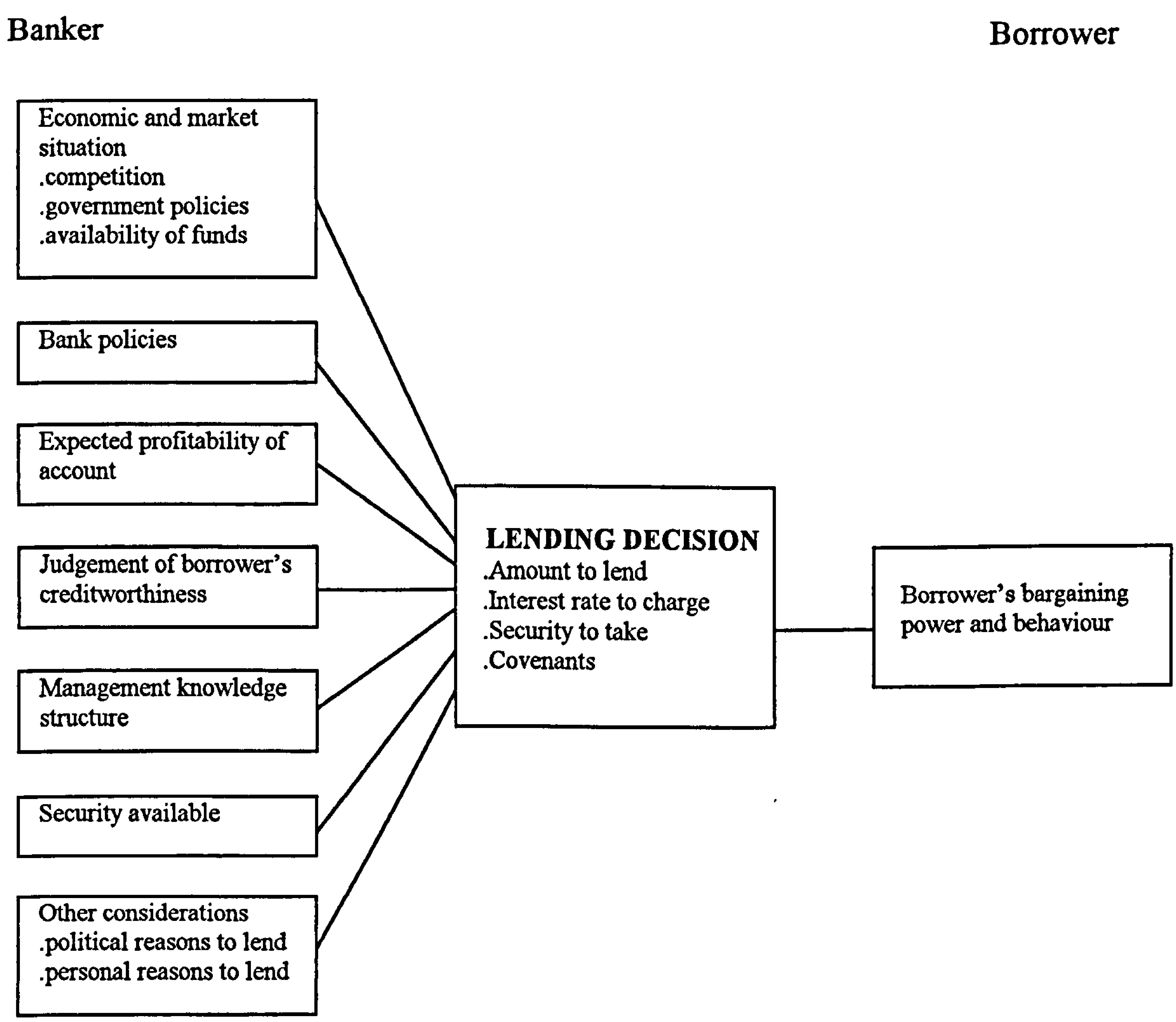
A study by NEDO (1986) identified two other approaches to bank lending assessment. The first, a traditional approach, is associated with more emphasis on judgement and on subjective or intuitive techniques, and less on the systematic gathering of information which is then objectively analysed. The bankers' attitudes in this approach are cautious and conservative, with a set of motivations and views that success is achieved by not failing. In the assessment of a borrower, the banker bases his or her degree of trust in the willingness to repay on the borrower's personal and business past records, rather than the nature of the business proposition envisaged for the future. On the other hand, the second or systematic approach puts more stress on information gathering and analytical procedures applied to projections of business behaviour.

However, as postulated earlier by Berry et al (1993b), NEDO (1986) had also found that in practice there is no distinct approach taken by bankers in their lending decisions. Elements of both traditional and systematic approaches are often included in an individual banker's assessment. Therefore, the nature of a banker's decision-making process seems to concur with that of Simon (1997), who believes in the combination of both intuitive and systematic or analytic techniques in producing effective decisions.

Another study in the UK, by Barona (1985), reveals the use of a mix of going concern and gone concern approaches, and the traditional and systematic techniques among bankers in their lending assessments. The systematic technique entails the use of both going concern and gone concern approaches in analysing the quantitative information required from the borrower. The most important quantitative information is the historical financial statements, such as profit and loss accounts and balance sheets, and the cash flow forecast. The traditional way of lending assessment requires the use of qualitative information obtained from the borrower. This includes the quality of management, the quality of the proposal presented, the general standing of the borrower in the community, and the situation of the borrower's premises. The bankers also seem to agree that honesty is an essential characteristics that makes up a 'management quality', and their judgements of the borrower's characteristics are based on subjective experiences.

To understand further the process of the banker's lending decision, Barona (1985) suggests the diagram shown in Figure 4.1.

Figure 4.1 Process of Bank Lending Decision



Source: Barona (1985)

According to Barona (1985), before making a judgement, the banker needs to take into account many elements, such as the borrower's creditworthiness, bank's policies, economic and market situations, and also the availability of collateral. The final outcome of the lending decision is an agreement in which the characteristics of the loan facility are made explicit. This agreement can be conceptualised as the final outcome of a bargaining process in which both the banker and borrower participate actively. It is also interesting to note that the above model reaffirms the influence of a variety of factors, discussed in Chapter Three, in the bankers' lending decisions. These forces of influence are invariably inter-linked, and cannot be looked at in isolation. Furthermore, the environment in which banks operate has become more complex and competitive, and therefore, there is a need to understand the behaviour of the market because attitudes and preferences of borrowers or customers are constantly changing.

It is also suggested that, in practice, the bankers use various 'rules of thumb' or heuristic judgements in their decisions. This is inevitable, due to the nature of situations where bankers are sometimes faced with a demand for quick decisions. But, putting too much weight on subjective judgements can lead to the dangers of errors in lending decisions. These have been illustrated earlier, in the preceding chapter, by the works of Kahneman & Tversky (1973), Tversky & Kahneman (1973), and Kahneman, Slovic & Tversky (1982).

In the United States, most of the literature also focuses on the issues of qualitative and quantitative approaches in the credit evaluation. Galbraith (1963), for example, argues that a qualitative evaluation of a borrower influences the bank's consideration to accept or reject a loan application. The bank requires that the borrower be satisfactory moral risk and reliability, and it may only lend to those in whose integrity it has confidence. However, Galbraith asserts that the willingness to lend is based upon the amount of uncertainty and credit risk the bank or banker is willing to accept, and that uncertainty is a matter of judgement or opinion.

Similarly, George (1991) stresses the importance of qualitative analysis in assessing the borrower's management and business risk. He makes this point:

"Evaluating management's capabilities and assessing the borrower's strategic position are two critical elements of a thorough credit analysis. When assessing management's capability, the key areas to consider are the experience and track record, the ability to use planning as a tool to guide the future, and the availability of reliable data and internal control to track performance against plans. To evaluate the borrower's business is by understanding the risks inherent in the borrower's business. It can be analysed through lending to a particular industry, borrower's strategic direction in relation to its competition, and on how the borrower conducts its day to day business".

Still (1984) does not believe in the quantitative techniques in the credit analysis. He argues that the analysis is an art, and not a science, and that it is based on certain principles. He also stresses that the use of advanced and sophisticated analytical tools does not ensure an improvement in credit decision-making, without a basic philosophical understanding of what credit analysis is designed to accomplish.

However, a study by Stephens (1980) found that bankers used a large amount of quantitative information in a systematic manner in their lending decisions. Meanwhile, Bjork (1983) insists that a good credit decision results from a quantitative analysis of the borrower's business, the industry in which it operates, and the market it serves. This analysis may include a review of the results of the business operations and financial conditions, and an assessment of expected future demand on cash, and the ability to generate cash.

Nevertheless, in practice, the qualitative and quantitative approaches are intertwined in the decision-making process of the bankers (Eisenriech, 1981; Fulmer, Gavin & Bertin, 1991; Goldenberg, 1993). Fulmer et al (1991) surveyed bank loan officers, and found the financial and quality of management factors as the two dominating the credit evaluation process. The required financial information found in the study was the historical balance sheets and income statements, together with the forecasted financial statements and cash flows. The qualitative characteristics assessed were the borrower's experience in the industry, his or her prior business success, good business plan, business ethics of top management, and knowledge of the business.

Eisenriech (1981), who advocates the combination of qualitative and quantitative approaches in lending decisions, gives this view:

"Successful commercial lending requires judgement more than it requires technical skills. An understanding of accounting, financial analysis and various types of loans may help a lender ask the 'right' questions. But the critical issues must be judged from the numerous variables under consideration. Judgement may also be required to verify those critical issues with objective sources".

Goldenberg (1993) focuses on the role of a bank manager in the lending decision. The banker normally undertakes a credit risk assessment of the borrower to determine whether the degree of risk is acceptable, the return is appropriate to the risk, and the exposure is consistent with the bank's strategy. The banker's task is to collect and analyse information, accurately assess the borrower's financial requirements, and contain the lending risks. In this assessment, the banker would also focus on the borrower's integrity and competence, and his or her strategic vision. In the end, the banker must be able to justify his or her lending and management decisions.

4.2.2 Quantitative Decision Models

Theoretically-based models have been applied with considerable success in credit analysis or bank lending assessment. Cohen, Gilmore and Singer (1966) tested a model that simulates the lending decisions of bank officers. They developed a flow model of the bank lending process, which contains eight main sections. They were (a) status of the firm's customer relationship, (b) evaluation of a new customer relationship, (c) credit evaluation, (d) check on legal and policy restrictions, (e) appraisal of the loan's purpose, amount, maturity, payback and security, (f) detailed recommendations, (g) record analyses and recommendations, and (h) follow-up and review.

Cohen, Gilmore & Singer (1966) also argue that modelling the bank officers' behaviour by programming the computer to perform judgements is analogous to those made by an experienced credit analyst. They insist that, while the model was not intended to be an exact replica of the analyses actually performed by bank officers, it can be a plausible formalisation of actual practices, and that it should produce the same results that bank officers obtain.

Orgler (1970) also developed a model for evaluating existing commercial loans. In his experiment, he found that factors influencing substandard loans were related to the characteristics of the borrowers, and not those of the bankers.

Snowdon (1978) attempts to deal specifically with loan selection by using a problem-solving approach. He outlines five major steps in the loan selection decision, involving listing and weighing the favourable and unfavourable factors affecting the company's creditworthiness.

In an earlier study by Myers and Forgy (1963), a scientific approach to loan application assessment was adopted using multivariate regression or discriminant analysis. This study identifies variables that best distinguish between loans that are eventually paid up, and loans that are written-off as losses. The best discriminant function composed of these variables is then used to compute a score for each loan application. This score is then compared with a certain cut-off rate to determine whether the application is accepted, rejected, or designated for a further analysis. Similarly, Ewert (1968) develops a model for screening trade credit applications by small firms. Meanwhile, Altman (1968) suggests a Z-score model to complement the more "qualitative and intuitive approach" of loan officers. He argues that the model could be a valuable tool for determining the overall creditworthiness of business customers.

Banks in the UK are also known to use a 'points system' to measure and define the likelihood of repayment of loans by potential borrowers (Davies & Kearns, 1992). This objective assessment is widely used in personal borrowings. The scoring points are given under certain headings, such as age, occupation, length of current employment, number of years at present address, own telephone, type of accommodation, marital status, number of dependants, and previous track record. The bank will ask a potential borrower to fill in an application form, which is then processed through the computer. If the bank's policy decides a certain score qualifies for the loan, the computer will produce an immediate response, which could be one of the following three alternatives: give loan, decline loan or make further inquiries. If the computer gives the third answer, the banker will make an additional check using CAMPARI before reaching a decision.

In the US, the credit scoring method is widely used in consumer lending, especially credit cards, and is becoming more commonly used in mortgage lending (Avery et al, 1996; Mester, 1997). The technique is used to predict the probability that a loan applicant or an existing borrower will default or become delinquent. Using historical data and statistical techniques, credit scoring tries to isolate the effects of various applicant characteristics on delinquencies and defaults. The method produces a 'score' that a bank can use to rank its loan applicants or borrowers in terms of risk. Information on borrowers is obtained from their loan applications and from other sources. Data such as the applicant's income, outstanding debt, financial assets, how long the applicant has defaulted or was ever a delinquent on a previous loan, whether the applicant owns or rents a home, and the type of bank account the applicant has are all potential factors that may relate to loan performance and may end up being used in the scoring. Regression analysis relating loan performance to these variables is used to pick out which combination of factors best predicts delinquency or default, and how much weight should be given to each of the factors. In this model, a higher score indicates lower risk, and the bank sets a cut-off score based on the amount of risk it is willing to accept. If the bank adheres strictly to the method, it would approve applicants with scores above the cut-off, and deny applicants with scores below.

Mester (1997) argues that this method would not necessarily predict with certainty any individual loan's performance, but it should give a fairly accurate prediction of the likelihood that a loan applicant with certain characteristics will default. There are obvious benefits in using the credit scoring in loan evaluation. First, it greatly reduces the time needed for the loan approval process. This time saving means cost savings to the banks and benefits the customer as well. Secondly, it improves objectivity in the loan approval process. This objectivity helps the banks ensure they are applying the same criteria to all borrowers.

Avery et al (1996) contend that the use of credit scoring not only reduces costs, but also increases the speed, accuracy and consistency of the credit evaluation process. It can reduce risk by helping bankers weed out borrowers posing excessive risk, and can also increase the volume of loans by better identifying creditworthy borrowers. However, the limitation of using the scoring method is that accuracy is still an open question. Furthermore, the scoring model does not tell what the future performance of an individual loan is going to be.

Other techniques that have been tried in credit or loan assessment include the use of a univariate model (Beaver, 1966), and probabilistic models (Wilcox, 1973; White & Turnbull, 1974).

The developments in the use of credit information and credit scoring techniques have changed the way loan or credit applications are assessed (Laudeman, 1996). In some cases, these models can overturn conventional wisdom on lending. For example, a business owner's personal credit history can give a better indication of repayment prospects than an exhaustive analysis of the company's financial statements. However, it is suggested that these techniques should be used in conjunction with the more traditional methods of credit analysis or loan assessment. The benefit is that a bank can use it to identify quickly business applications which are either very low or very high risks. The bank can therefore concentrate its expertise on applicants of moderate risk who require a more thorough evaluation.

4.3 SMALL BUSINESS LENDING

4.3.1 Theoretical Underpinnings

Academic research can be greatly facilitated by the existence of theories that guide the researchers towards understanding certain phenomena relevant to the study. However, the research in small business financing can be characterised by a lack of theoretical framework (Lanstrom, 1992). Similarly, there seems to be no accepted, structured, cohesive theory that can be used in understanding the bank lending decisions on small business customers. Nevertheless, recent researches into the financing of small businesses have been undertaken under the theory of modern finance (McMahon et al, 1993; Read, 1998). This concept of theory directs scholarly attention to the way in which the capital market enables allocation of scarce financial resources between individuals and business enterprises over time. A theoretical perspective that has a significant contribution to small business finance is that of agency theory. Its contribution has been highlighted by the works of Pettit & Singer (1985), Binks et al (1992), Berger & Udell (1993, 1995, 1996, 1998), Clay & Cowling (1996), Read (1998) and Cressy (1999). In this section, the general assumptions of the agency theory are presented, the theory's relationship to the financiers' behaviour is explained, and attempts to overcome agency problems arising from this relationship are discussed.

In general, agency theory considers a business enterprise from the viewpoints of various parties it might have, and is directed to the problem that occurs when they deal with each other (McMahon et al, 1993). This theory focuses on the relationship under which one or more persons (principal/s) engage another person (the agent) to perform some services on their behalf (Jensen & Meckling, 1976; Parker, 1984). This contract involves delegating some decision-making authority to the agent.

In the case of small business financing, the agent is typically a small business owner, and the principal is the supplier of external finance, notably the bank. The basic premise of agency theory is that both principal and agent are assumed to be rational economic-maximising individuals (Landstrom, 1992). Therefore, the separation of ownership and control may result in a problematic relationship, because there is always a possibility that the agent may not act in the best interest of the principal but instead acts in his or her own self-interest (Grossman & Hart, 1983; Peterson, 1994, and Read, 1998). It is also argued that the agency relationship problems are likely to be most significant when the business is small (Berger & Udell, 1995). The small business has considerable operational flexibility that makes it easier to transfer assets to other uses in response to a changing business environment, and this may have an adverse effect to the bank (Pettit & Singer, 1985).

The first problem that arises from the agency relationship is the asymmetry of information. This problem, sometimes referred to as 'hidden knowledge or information', occurs when one party to a transaction knows relevant information which has a material effect on the transaction, but which is not known to the other party (Binks et al, 1992; Amit, Brander & Zott, 1998). The small business owners when approaching the banks for loans always have an informational advantage over the bankers that sometimes leads them to overstate the soundness of their business projects in relation to the funding sought (Storey, 1994). These problems affect the willingness of some banks to enter into contract to supply the needed funds.

Pettit and Singer (1985) argue that the asymmetric information results from the differences in information available to small business owners compared to bankers. Small businesses have relatively high asymmetric information because of the relatively poor quality of their financial statements. Often, the best source of information is the small business owner himself or herself, his or her visions of the future, and his or her latent ingenuity to meet challenges. The only way to obtain the information is to have a constant communication with the small business owner, where as the banker may find it unrealistic and prohibitive. Holstrom (1979) and Binks et al (1992) concur that information in small business dealings is not perfect, and that to obtain it is costly and sometimes wasteful. The problem of asymmetric information can therefore impede the flow of funds to profitable firms, and the banks may choose to ration the amount of credit they grant, or extend credit only on relatively unfavourable terms (Stiglitz & Weiss, 1981).

The second problem to an agency relationship is the moral hazard, often described as 'hidden action' (Guesnerie, Picard & Rey, 1988). It is a situation where an agent does not act in a manner consistent with the contract with the principal, or in the principal's best interest (Read, 1998). The issue of moral hazard was first discussed in insurance markets where the insured parties could take actions that either decrease or increase the risk of hazard (Rothschild & Stiglitz, 1976). For example, after purchasing a motor insurance, the insured party could either drive safely or dangerously. Arrow (1973) and Pauly (1979), who conducted earlier work on moral hazard, found that it could also cause market failure.

In a situation of small business lending, the problem of moral hazard arises where the action of the owner who successfully obtained a bank loan is not directly observable by the banker. This borrower might use the funds for other purposes than stipulated in the contract, sometimes out of self-interest, even if such actions impose high costs on the banker (Holstrom, 1979). It can also occur where, during the contract period, the incentives of the two parties change, and as a result the riskiness of the contract is altered (Heffernan, 1996).

Cowling and Sugden (1995) point out that moral hazard arises in a situation where a borrower's probability is influenced by effort. When effort cannot be monitored sufficiently, this borrower may not put in the required effort. Therefore, the banks may be forced to take action by designing a lending contract that includes more effort from the borrower, such as obtaining higher collateral requirements.

The asymmetry of information can also give rise to a third problem, adverse selection, which causes inefficient allocation in the market (Heffernan, 1996; Amit et al, 1998). Furthermore, the market may be crowded with 'low quality' projects, simply because it is hard for the lenders to distinguish between good quality and bad quality projects. These lenders have to make decisions based on their knowledge of the borrower's skills and competencies (Read, 1998).

The situation of adverse selection was first described by Akerlof (1970), where sellers of used cars had private information on the quality of their cars, but buyers could not discern quality differences before purchase. As a result, the 'low quality' cars dominated the market, and the market 'selected' adversely. Akerlof (1970) also shows that adverse selection is inefficient, in that potentially efficient trades will not take place. Adverse selection problems also occur in many circumstances, such as in the insurance markets, where buyers may know their true risk better than the insurers (Pauly, 1974), or in labour markets, where workers may be more aware of their abilities than potential employers are (Spence, 1973).

The adverse selection occurs in small business lending because bankers cannot distinguish between the two types of borrower, the good risk and the bad risk. However, Cowling & Sugden (1995) argue that a bad risk borrower has an incentive to pretend to be a good borrower, and thus benefit from more favourable lending conditions. To prevent this problem, the bank may raise the collateral required from the good borrower, thus removing the incentive for the bad borrower to default. But, by doing so the bank also imposes an unfair cost on the good borrower.

The agency problems can give rise to costs (agency costs) in maintaining the relationship. These agency costs include monitoring costs, bonding costs, and residual loss (Landstrom, 1992; Peterson, 1994). Monitoring costs occur because the activities of the agent (borrower) must be monitored to ensure that he or she conforms to the contract. Bonding costs are incurred by the agent to guarantee that he or she will not take certain actions that would harm the principal (banker) and/or to ensure that the principal is compensated if the agent does take such actions. Residual loss, on the other hand, is a cost that results because of a divergence of decisions made by the agent, and those that would maximise returns to the principal.

The agency problems have therefore contributed significantly to the costs and the availability of funding to the small businesses. As noted earlier, the bankers often require greater level of compensation and protection to cover the risks and overcome the problems of asymmetric information, such as charging higher interest rates on the borrowers. De Meza & Webb (1987, 1999), for example, revealed that the inability of banks to discover the characteristics of entrepreneurs' projects leads to more investment than is socially efficient, and by raising interest rates above the market level, optimality will be restored. However, studies by Stiglitz & Weiss (1981) and Cowling & Clay (1996) found out that, on the contrary, adjusting interest rates does not reduce the problem of adverse selection or moral hazard. Adjusting the rates influences the riskiness of the average borrower as well as the demand for funds. Higher interest rates attract riskier borrowers, an adverse selection problem, and also induces borrowers receiving bank loans to alter their behaviour to adopt more risky projects, a moral hazard problem. Therefore, the banks may address the problems by restricting the amount of lending, rather than increasing interest rates (Stiglitz & Weiss, 1981). Alternatively, the banks may ask for higher collateral requirements, the use of loan covenant, and/or imposing some conditional features in the loan contract.

Collateral is the most common feature used in a loan contract to mitigate asymmetric information problems. It is also a powerful tool that allows banks to offer credit on favourable terms to small businesses. Collateral can either be pledging of assets owned by the firm or pledging of assets owned outside the firm, typically assets belonging to the firm's owners (Berger & Udell, 1998). The former reorders the claims of the firm's creditors by giving one of them priority through a security interest in specific assets. The latter enhances the claim of a single creditor by conveying recourse against additional assets outside the firm without diminishing the claims of the other creditors in the event of bankruptcy.

Theory suggests that collateral requirements help resolve adverse selection and moral hazard, as well as preventing credit rationing (Stiglitz & Weiss, 1981; Bester, 1985; Chan & Kanatas, 1985; Besankor & Thakor, 1987; Avery et al, 1998). They can be used to signal commitment on the part of the owner to the success of his or her business venture (Chan & Kanatas, 1985). Collateral reduces the moral hazard problem because the owner is unlikely to switch into a riskier project or to reduce effort unless he or she is willing to lose the collateral (Boot, Thakor & Udell, 1991). The level of collateral the small business borrower is willing to provide improves his or her incentives, and certainly influences the lending decision. However, it is also argued that pledging of assets belonging to the owners is a more acceptable form of collateral for small business lending (Avery et al, 1998). Since may small businesses cannot be viewed as financial entities separate from their owners, the personal assets of small business owners will play a key role in determining the availability of credit, for which they would otherwise not qualify or be able to negotiate better terms. On the other hand, pledging of a firm's assets can be viewed as a complementary arrangement that contributes to enhancing a small borrower's creditworthiness.

The covenant is another feature that can be imposed in the loan agreement by the banker, which limits the actions of the business owner, the borrower. It is intended to give the banker more control and prevent the borrower from engaging in activities against the banker's interest. This borrower must first obtain permission from his or her banker before embarking on any significant strategic changes such as changing is or her financial condition or strategy. Studies by Rajan & Winton, (1995), Berlin & Mester (1992), Magee & Sridhar (1994) and Park (1994) showed that by giving banks the right to renegotiate or call loans when covenants are violated, the efficiency of the loan contract is enhanced. It also gives more flexibility and control on the loan contract. Furthermore, control rights from covenants reduce borrower adverse selection and moral hazard (Smith & Warner, 1979). Berlin & Mester (1993) also found that firms with most credit risk and greatest moral hazard incentives are bound with the strictest covenants.

However, Berger & Udell (1998) argue that little is known on the use of covenants on small business loans, although there is some empirical evidence to suggest the use of covenants in bank lending to larger firms. Moreover, effective covenants generally cannot be imposed on the small firms, which do not have credibly prepared or audited financial statements (Ravid, 1996). Alternatively, to address the moral hazard problem, the banks can shorten the maturity of loan as a means to control the behaviour of the small firms (Berger & Udell, 1998). It is believed that the longer the loan contract is, the greater the opportunity for the borrower to alter his or her risk behaviour. Shortening the loan maturity can also be viewed as a particularly strong type of covenant. With a sequence of short-term loans, a banker can force re-negotiation frequently, whereas in covenants, re-negotiation can only be triggered by those covenants enumerated in the loan agreement.

Commitment loans can also be employed to help offset the asymmetric information problems of small businesses (Boot et al, 1987; Kanatas, 1987; Thakor & Udell, 1987; Avery & Berger, 1991; Cressy, 1992, 1996; Berger & Udell, 1998). A commitment loan is a forward contract issued by a bank to provide loan under pre-specified terms over some future time interval, unless the borrower's condition has suffered 'material adverse change', or the borrower has violated a covenant in the contract. A loan commitment can be in the form of overdraft, or in the case of US banks, a line of credit, where it allows the small business to borrow up to an agreed amount at any given time over a specified period. Whether and when a loan is taken down under the commitment are at the borrower's discretion. The bank is usually compensated in the form of fees charged on unused balances plus up-front fees and usage fees in some cases. This loan is not only flexible and convenient, but it also provides protection for the borrower against credit rationing or credit crunches of the general market conditions (Melnik & Plaut, 1986; Avery & Berger, 1991; Berger & Udell, 1992; Cressy, 1996; Morgan, 1994, 1998). Cressy (1996) argues that since loan commitment allows the borrower flexibility to decide when and the amount or levels to borrow irrespective of the market conditions, credit rationing cannot take place where borrowing levels are at the borrower's discretion. Furthermore, because of its fixed margin, the agreement also provides some insurance against subsequent deterioration in the borrower's credit rating.

A study by Morgan (1994) shows theoretically that loan commitment can solve a credit rationing problem. His study found that the fees on commitments reduce bankruptcy risk by shifting borrower's loan payments from high loan states towards low loan states. Reduced bankruptcy risk in turn reduces the bankruptcy premiums borrowers must pay, and entitles borrowers to large loan limits, thereby reducing the risk of quantity credit rationing. Meanwhile, Melnik & Plaut (1986) see a loan commitment as 'packages' of loan terms including the interest rate, the commitment fee, maturity, the credit quota or takedown limit, and collateral arrangements. Through offering various sets of contract terms, the bank may be able to reduce asymmetric information by inducing potential borrowers to reveal their types or to choose higher value projects. Boot et al (1987) argue that a loan commitment is capable of eliminating a distortionary effect of high loan interest rates. With a loan commitment, the bank can set the interest rate arbitrarily lower. Although this can cause losses, the bank is compensated by a commitment fee paid at the initial point in time. Since the commitment fee itself has no incentive effect, the loan commitment contract essentially gives the bank an additional degree of flexibility in contract design and enables it to circumvent the losses related to its inability to observe the borrower's action choice.

However, it is argued that a commitment contract can also exacerbate the asymmetric information problem. Because lenders are willing to offer a large number of 'packages', the borrowers may only select those that most appeal to them. These borrowers may be able to trade off 'more favourable' values of some loan variable for 'less favourable' values of some other loan variable (Melnik & Plaut, 1986). Furthermore, a commitment contract is usually signed at an earlier time where less information is available than for spot loan agreement, and thus it allows borrower to risk-shift to take advantage of the bank (Avery & Berger, 1991; Houston & Venkataram, 1994; Berger & Udell, 1998). Houston & Venkataram (1994) argue on the inability of the bank to take action on the borrower later in the relationship because of the pre-specified contract terms. Meanwhile, Avery & Berger (1991) found that bank risk is unambiguously increased by loan commitments because, in some states of nature, the bank is committed to honour the contract terms it might otherwise refuse. Nevertheless, Cressy (1996) argues that commitment loan (overdraft) in combination with up-front fees and collateral can still help overcome the moral hazard problem implicit in lending under asymmetric information.

There is also some literature that advocates relationship banking as an effective means for overcoming or reducing the agency problems. It is argued that banks can efficiently gain valuable information on a small business over the course of their relationship, and then use this information to help make lending decisions (Peterson & Rajan, 1994; Berger & Udell, 1995, 1998; Blackwell & Winters, 1997; Cole, 1998; Harhoff & Korting, 1998; Meyer, 1998; Udell, 1999). Information may be garnered over time through a series of loans extended to the borrower, the provision of deposit services, or the delivery of other financial services such as credit cards, trust accounts and investment services. Conditional on this experience, the bank may expect the loans to be less risky, and as a consequence reduces the interest rate charged and/or drops the collateral requirements (Blackwell & Winters, 1997). The small business may not only benefit in terms lower cost of funds but also in the greater availability of credit due to efficient gathering of information and protection against credit crunches (Berger & Udell, 1998).

Blackwell & Winters (1997) found a positive relation between a bank's monitoring effort and the loan's interest rate, and an inverse relation between the closeness of banking relationships and interest rate. They also found that banks would monitor less frequently firms with whom they have closer relationships, and ultimately charge them lower interest rates. Therefore, relationship banking is important because small businesses can significantly reduce their costs by establishing and maintaining closer ties with the banks. However, Blackwell & Winters (1997) also suggest that a small firm can only lower its cost by concentrating most of its borrowing with a single bank. This allows the bank to build an information advantage over other lenders. Because of potential competition, the bank's cost savings through reduced monitoring will be passed on to the firm in the form of lower interest rates. In contrast, Berger & Udell (1998) argue that the use of a single bank may also create a problem to the small business. If the bank itself experiences a liquidity problem, the credit withdrawn by the bank may signal unfavourable information about the small business, even though there has been no deterioration in the condition of that business. As a result, small businesses may maintain multiple banking relationships, creating higher transaction costs (Peterson & Rajan, 1994). Again on the contrary, Angelini et al (1998) found that firms dealing with several banks tend to pay lower interest rates. One solution to the problem of a single or multiple-banking relationship is for a small business to have a special relationship with one bank while borrowing from multiple banks, as been done with the 'housebank' system in Germany (Harhoff & Korting, 1998).

Peterson & Rajan (1994) examined how the relationship between a small firm and its creditors affects the availability and cost of funds to the firm. They found that the length of the relationship has a positive and significant effect on the availability of credit to small firms, but its impact on the cost is insignificant, although it is positive. Berger & Udell (1995) focused on the lines of credit obtained by small businesses, and found that interest rates and collateral requirements tend to decline with the length of the bank-borrower relationship. However, a study by Cole (1998) revealed that a potential banker is more likely to extend credit or loan to a firm with which it has a pre-existing relationship as a source of financial services but that the length of this relationship is unimportant. In addition, a banker is less likely to grant loan or credit to a firm if the customer relationship has lasted for one year or less, or if the firm deals with other financial institutions. This suggests that the role of relationships in the availability of credit is different from its role in the pricing, and also the private information about a firm generated by an institution is less valuable when the firm deals with multiple sources of financial services.

There is also a debate on whether the terms of lending ease or tighten over the course of the banking-small business relationship as the relationship strengthens and the bank gains access to more information. Peterson & Rajan (1995), for example, suggest that because of the asymmetric information at the earlier stage of the relationship where problems of moral hazard and adverse selection are large, the banks charge higher rates initially and reduce them in later periods after borrower types have been revealed. Meyer (1998) also found that as a relationship matures, banks typically reduce the interest rates charged and often drop the collateral requirements on small borrowers. Similarly, Boot & Thakor (1994) argue that small borrowers will only pay lower rates and do not pledge collateral later in the relationship after they have demonstrated some project success. The above findings further support the theory that potential gains can be reaped from a durable bank-borrower relationship, and that it can be an efficient means for overcoming asymmetric information and cost problems in small business financing. In contrast, Sharpe (1990) argues that, because of competition, lower interest rates are offered to all firms in their initial period, when banks know the least about them. Greenbaum et al (1989) also found that small borrowers were being subsidised in early periods, and being forced to pay higher interest in later periods, so that the terms of lending may worsen over the course of the relationship.

Diamond (1984, 1989), emphasises the relevance of a borrower's credit in the relationship. The longer the borrower repays his or her loans, the more likely the business or project is viable, and his or her trustworthiness. This leads to a building of good reputation, an increase in the availability of funds, and a relatively lower rate of interest charged on loans. On the other hand, borrowers who default in loan repayments may be denied credit thereafter. Consequently, this also leads to an improvement in the quality of borrowers, and the banks may gradually lower the lending rates.

Empirical evidence also suggests that characteristics of banks and borrowers can help in determining the cost and availability of credit to small businesses. Diamond (1991), Berger & Udell (1995) and Cole (1998), for example, argue that the age of the firm should influence whether a firm receives credit because firms in business for longer periods of time have established that they can survive the critical start-up period and have generated reputational effects. Thus, lenders should be more likely to extend credit to older firms.

On the other hand, Levonian & Soller (1996) and Peek & Rosengren (1995) found that smaller banks seemed to be the primary lenders to small businesses, while Berger & Udell (1995) reported on smaller banks having large proportions of their loans devoted to small businesses compared to larger banks. These findings should cause a concern for small business lending in the wake of a global banking consolidation through mergers and acquisitions. Clearly, consolidation would result in larger banks, and if these banks tend to devote only small proportions of their assets to small business lending, the availability of credit to the small businesses will be seriously affected (Hannan, 1991; Peek & Rosengren, 1995). On the contrary, studies have found that mergers between smaller banks do not seem to reduce small business lending (Peek & Rosengren, 1996, 1998; Strahan & Weston, 1996, 1998; Berger et al, 1998). They argue that at least some small banks, because of cost advantages in providing loans to small businesses, will survive the wave of consolidations and continue to serve the financing needs of small businesses. Furthermore, bank acquisitions would have a negative effect only when the acquired bank is small (Keeton, 1996; Berger & Udell, 1998), but a positive effect when the acquired bank is large. In addition, competitors in the same market may fill some of the lending gap if small business lending decreases as a result of a merger or acquisition in that market (Peek & Rosengren, 1998).

The literature on agency theory provides a useful insight into many matters in small business financing, and shows considerable promise as a means of gaining a better understanding on bank lending decision on small businesses. While it is evident that agency theory has contributed significantly to the understanding of the bank-small business relationship, it fails to consider the role of social and psychological aspects in that relationship. The problem is that the theory represents mainly the economic view of financing and tends to concentrate on concepts of project viability, efficient markets and the rational allocation of resources (Read, 1998). However, this view does not fully explain the flow of capital and that there is a need to integrate the 'economic' with concepts about social process (Sargent & Young, 1991). Furthermore, raising finance is a complex and dynamic process and may be affected by a variety of factors, both economic and social. Sargent & Young (1991) also put forward a 'contextual approach' which acknowledges that individual characteristics such as personality and competencies, occupational, social and educational experiences, as well as perceptions and expectations, also play a major role in the funding decisions. Therefore, by taking this broader approach which recognises and incorporates the 'context' of individuals (lenders) within traditional economic thinking in understanding the small business financing, a new framework is created within which to study the bank lending decisions on small businesses.

4.3.2 Lending Attitudes and Practices of Banks

As mentioned earlier, the major task in the bank lending decision is to overcome the asymmetric information in order to reduce or avoid credit risk. Banks must not only investigate but also monitor the activities of would be and existing borrowers. The gathering, processing and analysing of quality information provides the vehicle for developing a profile of a borrower's creditworthiness, while financial contracting attempts to reduce the asymmetric information problems between the lenders and borrowers. This section of the chapter focuses on the lending attitudes and practices of banks from both theoretical and practitioner perspectives in a further attempt to understand the lending decisions of the bankers on small businesses.

It is often argued that substantial differences occur among the bankers in their attitudes and practices towards small business lending. Some bankers are apparently more sensitive to small business customers than are others, and some go considerably further to accommodate their credit needs. These bankers might even be inclined to relax some restrictions, depending on loan demands, competitive pressures, and the profitability to the banks. Brooms et al (1983) assert that:

"Lending policies of banks are not uniform. Some bankers are extremely conservative, while others are more venturesome in the risk they will accept. If a

small firm's loan application is neither obviously strong nor obviously weak, its prospects for approval depend as much upon the bank as upon the borrowing firm……… In addition to variations in their conservative or venturesome orientation, banks also differ in length of loans, interest rates, types of security required and other such features. The bank's reputation for sticking with a firm in times of adversity is also pertinent. Some banks are more flexible than others in assisting a firm that is experiencing temporary difficulty. The beginning small business certainly needs a banker who is willing to make reasonable concessions in times of stress".

Understanding the attitudes and practices of bankers when dealing with small businesses can perhaps explain these differences. It can hopefully lead to an understanding on the manner in which the bankers assess in deciding or rejecting the small business propositions. Furthermore, because of the peculiarity of the businesses, they require a greater deal of judgement by the banker, compared to larger companies where historical and financial information are readily available. In addition, a bank has to spend as much time processing its loan application, although the loans are relatively small in magnitude. On top of that, the assessment tends to focus more on the personal characteristics and the managerial capabilities of the owner.

Traditionally, the approaches to the assessment of creditworthiness of a small business borrower have been based on the experience and skill of bankers in applying the basic lending principles, such as the 5Cs and CAMPARI, in their decisions. An earlier study on small business lending found that 'quality of management' and 'risk of default' are the two most important factors that bankers considered in their decisions on whether to accept or reject a small business loan proposition (Ulrich & Cassel, 1974). The findings suggest that a firm that attempts to avoid or correct conditions considered risky by banks, and striving in various ways to demonstrate the competence of its management, will increase the probability of having an application for bank loan approved.

A similar study, using the factor analysis technique, was developed by Ulrich and Arlow (1981). In this study, the researchers found that three of the four definable factors that greatly influence the lending decisions are risk-related, while the fourth is related to the cost of the loan. They also suggest that a typical loan arrangement in a small business lending is characterised by a set of terms such as the rate of interest, size of loan, collateral requirements, balance requirements, guarantee, maturity, schedule of repayment, and covenant restrictions. These terms are however dependent on the characteristics of the banker, and upon information available to the bank on the borrower.

Further studies also found that bankers apply both subjective and objective methods in determining their decisions to accept or reject small business loan propositions (Jones, 1982; Memon, 1984). These researchers identified nine criteria that may be considered important elements in the bank's decision-making process. They are collateral, initial capitalisation, credit history, deposit-relationship, future deposits, market area, managerial experience, pro-forma or actual data, and bank policy. Although some criteria are relatively more important than others, the bankers take many or all of the criteria into account when they evaluate small business propositions.

A survey by Fertuck (1982) also revealed a number of both quantifiable and non-quantifiable criteria used in the decisions on lending to small businesses. These include security, financial strength, business ability, and honesty. Security is the borrower's ability to generate cash flow to repay the loan, while financial strength is judged by past financial statements, projected cash flow, and nature of business. Business ability is evaluated by examining the past track record in the business, particularly the repayment history of other loans as evidenced by credit ratings, bankruptcy and/or recommendations from the borrower's banker. On the other hand, evidence of competence and honesty is normally obtained by a 'gut feel' observed during interview or site inspection. Similarly, NEDO (1986) found a combination of traditional and systematic approaches being used in bank assessment of small business loan propositions in the UK. As explained earlier, the traditional approach is associated with more emphasis on judgement and on subjective or intuitive techniques, while the systematic approach lays more stress on information gathering and on analytical procedures applied to projections of business behaviour.

There are a number of studies focusing on negative factors that result in the rejection of small business propositions. Struck and Glassman (1983), for example, found that the main reasons are: not enough owner's equity in the business, poor earning records, new firm with no established record, collateral of insufficient quality, and slow or past due in trade credit and loan repayment. Buttner and Rosen (1992) uncovered the reasons as bad timing, insufficient collateral, inability to develop good chemistry, excessive loan request, lack of demonstration of critical management skills, insufficient market research, incomplete business plan, and lack of business experience and entrepreneurial skills.

Fertuck (1982) also identified several factors that contributed to the rejection of small business loan propositions. These factors, which are ranked in order, are: poor credit rating, lack of competence, poor cash flow, poor market for product or service, poor collateral, fraud and bankruptcy. On the other hand, Barrett (1990) argues that the reasons for loan rejections are: poor communication with the banker, rapid expansion of business as against the capital available, overly optimistic proposal exceeding industry projections, past misuse of loan funds, and a rapid inventory build-up. Desmond (1991) gives the reasons for small loan rejection as no track record of business, no security offered, too risky, require guarantees, performance factors, and lack of personal investment. On performance factors, he cites the following reasons for not granting the loans: gearing too high, cash flow record, creditor/debtor ratio, level of profits, incorrect assumptions, poor presentation, and insufficient knowledge of finance. A study by Read (1998) found that the main reasons for refusing to finance the small businesses are lack of collateral, insufficient turnover, and poor cash flow.

A considerable number of articles have also highlighted the distinct features in the lending assessment of a small business proposition. A business plan is usually required in small business lending, compared to that of conventional lending. Barrett (1990) contends that approval procedures for small business loans are more formalised, and relationships with bankers less personal. As a result, a written loan proposition is often needed in the assessment. The proposition has to answer questions a banker may want to ask, such as how much money is needed, for how long, for what purpose, how the loan will be repaid, and the borrower's contingency plan if something goes wrong. Its contents must include the history of the business, an evaluation of the market, product information, and financial statements. Justis (1982) explains the need for a small business borrower to incorporate a feasibility study or a business plan of the prospective business or venture. The business plan should explain how the business operates, its profitability, and the ease of repayment ability for the loan. Heard (1980) also stresses that small business owners should produce business plans so that they can plan ahead. Often, these businessmen are immersed in the day-to-day operation of their business and are overtaken by events, sometimes with disastrous consequences. Meanwhile, it is argued that banks are increasingly taking the view that lending should be based primarily on the analysis of borrower's cash flow and business plan, with the availability of security being regarded as an important but secondary consideration (Mason & Harrison, 1996).

Hutchinson and McKillop (1992) suggest that the collateral being requested for small business loans is too high. They also argue that by being primarily concerned with security in lending, the banks sometimes fail to take full account of the potential for future income growth arising from new high-risk projects. However, they point out that the concept of risk-return relationship applies in small business lending. Because the small business is perceived as high risk relative to larger ones, the bank will naturally charge higher interest rates and/or raise collateral requirements. In addition, where risk rises beyond the bank's tolerance level, there is a rationale for the bank to refuse funding. Evidence has shown that small businesses have a higher probability of failure and subsequently defaulting on their loans (Jovanovic, 1982; Dunne, Roberts

& Samuelson, 1987; Bates, 1991). Therefore, the banks' attitudes to lending assessment, taking into consideration the overriding responsibility to their risk-averse depositors, are considered normal and proper.

Evidence has also suggested that approaches taken by some of the bankers are biased (Johns, Dunlop & Sheehan, 1989; Berry et al, 1993a; Lambden & Targett, 1993; Deakins & Hussain, 1994; Binks & Ennew, 1995; Clay & Cowling, 1996). Deakins & Hussain (1994), for example, voice concern on the adverse selection problem in the decisions on lending to small businesses. They point out that some small business propositions which had high potential for growth and profitability were turned away by the banks.

Deakins & Hussain (1994) and Fletcher (1995) also found out that bankers placed great importance on the extent of gearing, financial assets information for both the business and personal asset of the owners, and justification of income generation. The bankers gave less emphasis to other factors that are equally important to the success of business such as business acumen of the owner, management skills and business training, efficient use of resources, and technical knowledge.

Binks and Ennew (1995) argue that the approach taken by the banks falls between income gearing and capital gearing. Income gearing focuses on the future income stream, while capital gearing emphasises the value of collateral to be provided. Because of asymmetry of information, these banks may risk adverse selection and moral hazard in their lending decisions. There is the potential for bad projects to be financed if sufficient collateral is made available. On the other hand, if collateral requirement is insufficient, credit rationing may occur, and as a result viable projects may be refused funding.

Lambden & Targett (1993) concur that the banks make two major mistakes in their approaches to assessing the small businesses. The first is to apply similar techniques used in assessing large firms to the small businesses, where the latter are less likely to have sophisticated operations. Secondly, the banks tend to assess the person not the business, and if they do, they are much more concerned about how the loan would be repaid if the business failed than with the prospect of success. Lambden & Targett (1993) argue that personal qualities and the ability to make a business succeed are often critical, but their assessment is a subjective matter.

Nevertheless, recent literature on the role and conduct of banks in respect to small business financing suggests that new techniques be employed to cater specifically for small business loan application, as the traditional method may no longer be applicable (Laudeman, 1996; Clarke, 1998). The assessment must include unquantifiable factors such as character, skill and experience of management, purpose of loan, ability to dispose of assets to generate cash, and the availability of unused credit source, or the ability to renew or extend credit.

This argument has been put forward earlier by Heard (1980), who observed a fundamental change in the nature of small business lending in the UK from that of transaction lending to relationship lending. Under the new approach, a banker seeks an increasing knowledge and understanding of customers, and the problems he or she encounters. From there, this banker would be able to evaluate a business proposition on a wider spectrum, where the viability of the business can be assessed more objectively.

There are also suggestions that heuristic or intuitive judgement has been used widely in decisions on lending to small businesses (Fertuck, 1982; Salisbury, 1984; Jankowicz & Hisrich, 1987). This judgement, which is common in most decision-making situations, is a response to the need for rapid decision, sometimes too rapid to allow for sequential analysis of the situation (Simon, 1987). This is largely true in the small business situation, where the opacity of information and the peculiarity of the business sometimes encourage the bankers to bypass in-depth analysis in their decisions.

Salisbury (1984) expresses this view:

"Basic credit decisions are often based solely on considerations of the heart (often biased), head (analytical) or gut (experience). Using these guidelines, I have generally found that if my heart overrules my head, the loan has almost uniformly been a poor one. If my head overrules my gut instinct, the resulting loan may sometimes be a poor one. In looking back at poor loans, I should have followed my gut instinct more often".

Jankowicz and Hisrich (1987) argue that when making lending decisions, the information, policies and values of a banker are combined into an informed judgement by a subjective process. On the other hand, Bastick (1982) contends that an intuition is formed from the integration of disparate information, some of which is obviously not related to the issue at hand. It then leads to a conclusion about the overall issue that might not have arisen from consideration of each component of the situation.

However, the use of heuristics or intuition as a basis for lending decisions can also lead to serious errors in the judgements (Kahneman, Slovic & Tversky, 1982; Barona, 1985). Barona (1985) cites an example where bankers making lending decisions based exclusively on the past honesty of the borrower, without giving consideration to the environment in which the borrower operates, are at risk of committing error in their judgements. Two of the errors, availability heuristics and representative heuristics, mentioned by Kahneman & Tversky (1972) and Tversky & Kahneman (1974), are commonly associated with making judgements on certain qualitative attributes such as the character and capacity of the borrower. Undeniably, the use of heuristic judgement can also lead to good decisions. As Simon (1997) concludes, every manager needs also to be able to respond to situations rapidly, a skill that requires the cultivation of intuition over many years of experience and training.

An alternative to heuristic or intuitive judgements is the use of quantitative or analytic models. Earlier attempts to develop credit-scoring models for credit or loan evaluation have been made by Cohen, Gilmore & Singer (1966), Altman (1968) and Orgler (1970), Edmister (1971), Doreen (1983), Leonard (1992, 1996) and Eisenbeis (1996). However, only Edmister (1971), Doreen (1983) and Leonard (1992) are known to have focused the models specifically for small businesses by using step regression to financial ratios, multivariate techniques and discriminant analysis, respectively.

In the US, many banks are beginning to use scoring models to evaluate small business loan applications (Mester, 1997; O'Connor-Clarke, 1998), although the technique has long been employed in consumer lending and mortgage lending (Barefoot, 1997). The surge of this application is mainly due to the advent of new methodologies, enhanced computer power, and increased data availability and accessibility that help to make accurate scoring possible. Bankers also can take advantage of increasingly sophisticated and affordable analytical tools to reduce both costs and bad decisions in their lending assessments.

O'Connor-Clarke (1998) further argues that credit scoring provides a quick, accurate risk assessment of potential borrowers, rank-ordering them by the relative amount of risk they represent. The technique focuses on the characteristics of the owner as the most important indicator of small business loan performance rather than the business itself. It thus allows bankers to make approval decisions and determine pricing structure using the most relevant information. In addition, credit scoring streamlines the lending process, saving bankers' time and money, while enabling them to process more loans and creating more opportunities for borrowers.

However, the increased use of credit scoring can also increase the potential for disparate impact problems or selection bias in the lending decisions (Barefoot, 1997). Barefoot points out:

"The very fact that human judgement is largely removed from the process means that the factors the computer is using to make decisions, and how those factors are

evaluated, takes on even more importance. If the scoring system causes different outcomes for different groups, and those differences cannot be justified, then illegal discrimination may have occurred".

Furthermore, to build a good scoring model needs sufficient historical data, that reflect loan performance in periods of both good and bad economic conditions (Mester, 1997). But the asymmetry of information in the small business lending situations means that there is less information with which to build a good model. As a result, this model may not accurately predict the future small business loan performance.

4.3.3 Summary and Conclusion

Looking back at the academic and practitioner literature on bank-small business relationships, the researcher found numerous articles dealing with how decisions are made by bankers in response to the problems of asymmetric information. Studies on the subject have been going on for decades, and various committees have been formed in the UK to discuss the availability of bank finance to the small business sector. It is interesting to note that findings from these studies have contributed significantly to the enrichment of literature on the subject. A variety of techniques and methods used in the studies have also been presented, while theories on management, economics and finance were applied to enhance the academic value in the literature.

The existing literature is clearly an important source of information in developing an understanding of bank lending decisions on small businesses. Unfortunately, most of this literature focused only on the practices and experiences of bankers in the United States and the United Kingdom. The researcher did not find any material that specifically discussed bank lending decisions in the developing countries, although strong evidence suggests that the issue of 'finance gap' exists too in these countries (Peterson & Shulman, 1987). A similar issue has been given consideration attention by a number of parties in Malaysia. As pointed out in the first two chapters, the economic contribution of the small business sector is recognised, and the sector has been accorded a significant role in the process of industrialisation. It has also been given emphasis in the government's objective of achieving the country's developed economy status by the year 2020. Equally important is the role of commercial banks. What do the banks do about it? Are commercial banks in Malaysia really paying attention to the small business sector?

Therefore, this study will complement and extend previous studies as well as capturing many of the nuances and complexities of banks' decisions on lending to small businesses. Are the techniques and practices of banks discussed in the literature applicable to the banks in developing countries? Although the Malaysian banking system is modelled to a considerable extent on the British banking system, there is a possibility of distinction in the ways lending decisions are made because of the difference in local laws and culture, and other environmental situations. Thus, it is hoped that any findings on this study may contribute to an increased understanding on a subject where the existing literature has so far been found to be lacking.

CHAPTER FIVE

5. RESEARCH METHODOLOGY

5.1 INTRODUCTION

The purpose of this chapter is to detail the appropriateness of research designs and techniques used in this study. The selection of the research design is strongly guided by specific assumptions about the research to be conducted. This is based on the premise that a consistent and previously developed research, knowledge or theory on bank lending decisions on small businesses is lacking. Furthermore, there was no prior research being conducted in Malaysia on similar issues. For these reasons, the research methodology will be designed to generate findings that indicate an in-depth understanding of the process of a bank's lending decision on small businesses, while providing breadth in terms of research implications for future research.

The elements of the methodological approach are presented first in the chapter, followed by a discussion of (a) the choice and rationale of the research design, (b) the sampling choice, (c) the data collection procedure, and (d) the process of data analysis.

5.2 NATURE OF RESEARCH DESIGN

Understanding the appropriateness of a research design is a major step leading towards the accomplishment of a research objective. This assertion holds true because completing successful research depends on having a clear defined purpose and access to useful data pertinent to that research. And the purpose of the study defines the type of research design that should be used.

Singleton, Straits & Straits (1993) define research design as a complete, detailed strategy worked out before the data are collected. The design consists of a clear statement of the research problem, as well as plans for gathering, processing and interpreting the observations intended to provide some resolution to the problem. Kerlinger (1986) notes two basic purposes of design, that is, to control for variations, and to provide answers to questions being researched.

Philliber, Schwab & Samsloss (1980) describe the research design as a 'blueprint' of research, dealing with at least four problems: what questions to study, what data are relevant, what data to collect, and how to analyse the results. Yin (1989) sees it as an action plan for getting from here to there, where 'here' may be defined as the initial set of questions to be answered, and 'there' is some set of conclusions (answers) about these questions. Yin (1989) reiterates that the main purpose of the research design is to help to avoid the situation in which the evidence does not address the initial research questions. A research design can also act as a logical model of proof that allows the researcher to draw inferences concerning causal relations among the variables under investigation (Nachmias & Nachmias, 1976).

Bryman (1989) distinguishes between the research design and the research method. He suggests that the former is the overall structure and orientation of an investigation, while the latter tends to be mainly associated with the techniques of data collection. He also identified five main designs frequently used in social science research. These are experimental, survey, qualitative research, case study and action research designs.

1. Experimental Design

Experiment is one of the main elements of scientific research. The key features of this design are manipulation and control. The researcher here actively manipulates aspects of a setting, either in the laboratory or in a field situation, and observes the effects of that manipulation on experimental subjects. There is also a 'control group' which acts as a point of comparison with the group of subjects who receive the experimental manipulation. However, it is difficult to conduct this research within real organisations or where there is no captive population from which to draw the subjects or groups (Easterby-Smith, Thorpe & Lowe, 1991).

2. Survey Design

Survey research is one of the most frequently employed approaches in social science. It involves the gathering of data or information from a sample using a standardised method, such as questionnaires or interviews. The samples tend to be large, and the emphasis is not usually on individuals in a sample but rather on the generalised statistics derived from all the individual cases (Adams & Schvaneveldt, 1985). The researcher also does not manipulate any of the variables or apply control conditions to the subjects under study.

3. Qualitative Research Design

This research is focused on the way people interpret and make sense of their experiences and world in which they live (Holloway, 1997). The emphasis is on subjectivity rather than objectivity, allowing flexibility in the process of conducting research, an orientation towards process rather than outcome, and an explicit recognition of the impact of the research process on the research situation (Cassell & Symon, 1994).

4. Case Study Design

Case study involves a detailed investigation, often with data collected over a period of time, of one or more organisations, or groups within organisations, with a view to providing an analysis of the context and processes involved in the phenomenon under study (Hartley, 1994). Since it includes only one, or a very few groups or subjects of study, it can afford to deal with all pertinent information or aspects of the problem. Case studies have also been widely used in studies of organisational behaviour, especially in understanding organisational innovation and change (Burns & Stalker, 1968; Biggart, 1977; Pettigrew & Whipp, 1991; Pettigrew, Ferlie & McKee, 1992). The strength of case studies lies especially in their capacity to explore social processes as they unfold in organisations.

5. Action Research.

Action research aims at solving specific problems within a programme, organisation or community. The research explicitly and purposefully becomes part of the change process by engaging the people in the organisation or community in studying their own problems in order to solve those problems (Whyte, 1989). The approach tends to be less formal, and the people are often directly involved in gathering the information and in studying themselves. The findings are used internally to solve specific problems within the organisation or community. The focus here is on specific problems rather than the overall issues within the organisation or community (Patton, 1990).

Clearly, the choice of the research design depends heavily on the nature of the subject being researched, and the questions being addressed. The choice also allows one to make a judgement about what form of inquiry is best suited for the investigation (Guba & Lincoln, 1989; Patton, 1990; Kuzel, 1992).

5.3 QUALITATIVE VERSUS QUANTITATIVE RESEARCH

This section focuses on a continuing debate about the adoption of a qualitative or quantitative research approach in social science. The arguments have some merits, and all are put forward by researchers who sincerely believe in the superiority of their particular views. Furthermore, these discussions can also provide the researcher with an idea to plan a strategy in determining the appropriateness of the research design for a study.

It has been claimed that past research in social science had been dominated by the use of quantitative methods (Morgan & Smircich, 1980). However, it is also argued that qualitative research has long been employed by social scientists, although the surge of interest in its potential only came in the 1960s (Bryman, 1988). This shift was most striking in large-scale evaluation research effort, which previously had been almost exclusively quantitative in nature, but now saw the inclusion of major qualitative components too (Fetterman, 1982; Firestone & Herriot, 1984).

In social science, the terms 'quantitative research' and 'qualitative research' came to denote divergence in not only the data collection procedures, but also the philosophical, ideological and epistemological assumptions about the social world (Rist, 1977; Filstead, 1979; Guba & Lincoln, 1981; Bryman, 1988). The quantitative researchers are committed to a positivist or traditional approach to the study of society (Filmer et al, 1972). They are presuming that the social world exists externally and that its properties should be measured objectively (Morgan & Smircich, 1980). This presumption provides the philosophical underpinnings for what is commonly called the 'scientific method' (Lincoln & Guba, 1985). The only forms of knowledge recognised are the empirical and the logical, the former represented by natural science and the latter by logic and mathematics (Hughes, 1976). The focus of research is on facts, causality, fundamental laws and hypothesis formulation, and the method involves taking large samples, and operationalising the concept in a way which enables the facts to be measured quantitatively (Finch, 1986; Bryman, 1988; Holloway, 1991; Bailey, 1996). As described by Cassel & Symon (1994):

"The assumption behind the positivist paradigm is that there is an objective truth existing in the world which can be revealed through the scientific method where the focus is on measuring relationships between variables systematically and statistically".

On the other hand, the qualitative researchers emerge from phenomenological and interpretive paradigms. These advocates view the world as socially constructed and subjective (Filmer et al, 1972; Creswell, 1994). Their research is focused on the meanings, the understanding of what is happening, and on the development of ideas through induction from the situation. The emphasis is on constructivist approaches where there is no clear-cut objectivity or reality. As Fryer (1991) notes:

"Qualitative researchers are characteristically concerned with attempting to accurately describe, decode and interpret the precise meanings to persons of phenomena occurring in their normal social contexts and are typically pre-occupied with complexity, authenticity, contextualisation, shared subjectivity of researcher and researched, and minimization of illusion".

Advocates of qualitative research also believe that the social world constitutes some form of open-ended process where researchers can no longer remain as external observers and measuring what they see (Morgan & Smircich, 1980; Locke, Spirduso & Silverman, 1987). They must therefore move to investigate from within the subject and employ research techniques appropriate to that task. Miles & Huberman (1984) contend that qualitative research is largely an investigative process where the researcher gradually makes sense of a social phenomenon by contrasting, comparing, replicating, cataloguing and classifying the object of study. Marshall & Rossman (1989) argue that this entails immersion in the everyday life of the setting chosen for the study, where the researcher enters the informant's world and through ongoing interaction, seeks the informant's perspectives and meanings.

Meanwhile, Lincoln & Guba (1985) describe the qualitative approach as appropriate for understanding a phenomenon as it occurs, without a priori hypotheses, experimental control, or the isolation and manipulation of variables. Its purpose is to gain a 'rich' understanding of the salient issues and their interrelationships to describe a particular socio-phenomenon. They also encourage researchers to search for a 'pattern of truth', and these patterns must be searched for the sake of understanding, not for the sake of prediction and control. Lincoln & Guba (1985) also observe a changing paradigm among researchers in many disciplines from a positivist view to a naturalistic view. These researchers who adopted new instruments and looked in new places to expand their knowledge, found that the positivist's paradigm and its associated methods did not serve their purposes.

However, it is also argued that the distinction between the techniques used in qualitative and quantitative methods is not always clear (Easterby-Smith, Thorpe & Lowe, 1991). Some techniques such as interview can be used for gathering quantitative or qualitative data. Howe (1988) shows that quantitative and qualitative methods are 'inextricably intertwined', not only at the level of specific data sets but also at the levels of study design and analysis. Salomon (1991) points out that the issue is not quantitative-qualitative at all, but whether the researchers are taking an 'analytic' approach to understanding a few controlled variables, or a 'systematic' approach to understanding the interaction of variables in a complex environment. Bryman (1988) argues that quantitative research and qualitative research are each appropriate to different kinds of research problem, implying that the research issue determines which style of research is employed. Walker (1985) concurs that certain questions cannot be answered by quantitative methods, while others cannot be answered by qualitative ones. This implies that the decision whether to use a quantitative or qualitative approach should be based on technical issues regarding the suitability of a particular method in relation to a particular research problem.

There are some advantages and disadvantages of using either method. For quantitative research, the advantage is that it is possible to cover a wide range of situations in a faster and economical way, especially when statistics are aggregated from large samples. This gives a broad generalisable set of findings presented succinctly and parsimoniously (Patton, 1990). However, the approach tends to be inflexible and artificial, and is not effective in understanding the process or significance that people attach to notions. The advantages of using qualitative research are that it has the ability to look at change processes over time, understand people's meanings, and adjust to new issues and ideas as they emerge. The gathering of data is also seen to be natural rather than artificial. Nevertheless, the process of collecting and analysing data is highly labourious and often generates much stress (Miles, 1979). The fieldwork is also demanding with the sheer range of phenomena to be observed. The recorded volume of notes, and the time required for write-up, coding and analysis can be overwhelming. Furthermore, the use of data may be difficult because the methods of analysis are not well formulated.

In social science research, the qualitative approach has now been widely employed (Hammersley, 1992). It has also been adopted by the educational researchers (Borg & Gall, 1989). According to Bryman (1988), the increase in interest in qualitative research is due to a growing awareness of phenomenology which spawns interest in methods like participant observation and unstructured interview. Bryman (1988) also believes that the 'scientific' approach is not appropriate to the study of people, because it fails to take into account the differences between people and the objects of the natural sciences.

Several qualitative researchers have also identified the unique characteristics that are inherent in the approach. These are:

1. It occurs in natural settings, where human behaviour and events occur (Merriam, 1988).
2. The researcher is the primary instrument in data collection rather than some inanimate mechanisms (Lincoln & Guba, 1985; Merriam, 1988; Eisner, 1991).
3. The data that emerge from a qualitative study are descriptive, that is, data are reported in words rather in numbers (Locke et al, 1987; Merriam, 1988; Marshall & Rossman, 1989; Fraenkel & Wallen, 1990).
4. The focus is on participants' perceptions and experiences, and the way they make sense of their lives (Locke et al, 1987; Merriam, 1988; Fraenkel & Wallen, 1990) The attempt is therefore to understand not one, but multiple realities (Lincoln & Guba, 1985).

5. Qualitative research focuses on the process that is occurring, as well as the product or outcome. Researchers are particularly interested in understanding how things occur (Merriam, 1988; Fraenkel & Wallen, 1990).

5.4 TRIANGULATION

There are also those who advocate the use of multiple methods in research (Webb et al, 1966; Denzin, 1970; Smith, 1975; Mathison, 1988; Patton,1990). They argue that by mixing research methods, the weaknesses in each single technique will be compensated by the counter-balancing of strengths of another. Ideally, each technique chosen for a particular study would approach the problem from a different direction.

The use of multiple methods or triangulation originated from navigation and military strategy that uses multiple reference points to fix an object's exact location (Smith, 1975). It is believed that by collecting different kinds of data bearing on the same phenomenon, the accuracy of the researcher's judgement can be improved (Jick, 1979). Webb et al (1966) suggest that researchers are likely to exhibit greater confidence in their findings when these are derived from more than one method of investigation. Denzin (1970) sees it as a means of examining the same research problem and enhancing claims concerning the validity of conclusions that could be reached about the data. Patton (1990) also argues that triangulation is a powerful solution to the problem of relying too much on a single data or method, thereby undermining the validity and credibility of findings because of the weaknesses of any single method.

Triangulation is the most important strategy for discovering richer and more informative data (Mathison, 1988). Although the stated purpose of triangulation is to try to converge on the truth, Mathison (1988) insists that what usually happens is that the information acquired through using several different techniques is inconsistent or contradictory. These contradictory findings, he feels, are as important as actual convergence of data, because they can enrich the model constructed by the researcher.

Rossman & Wilson (1991) give three broad reasons to support the use of triangulation: (a) to enable confirmation or corroboration of data from different sources, (b) to elaborate or develop analysis, providing richer details, and (c) to initiate new lines of thinking through attention to surprises or paradoxes, 'turning ideas around', providing fresh insights. Greene, Caracelli & Graham (1989), after reviewing 57 mixed-method evaluation studies, propose that such studies can help sequentially, and can expand the scope and breadth of a study by using different methods in different components.

Triangulation is not only used to examine the same phenomenon from multiple perspectives, but also to enrich an understanding by allowing for new or deeper dimensions to emerge. Denzin (1978) identifies four basic types of triangulation: (a) data triangulation - the use of a variety of data sources in a study, (b) investigator triangulation - the use of several researchers, (c) theory triangulation - the use of multiple perspectives to interpret a single set of data, and (d) methodological - the use of multiple methods to study a single problem.

According to Jick (1979), the most prevalent attempts to use triangulation were reflected in efforts to integrate fieldwork and survey methods. Here, the researchers applying the qualitative approach may systematise their observations, utilise sampling techniques, and develop quantifiable schemes for coding complex data sets. Thus, this survey research may contribute to greater confidence in the generalisability of results. Burgess (1984) also argues that field methods which do not encompass observation, informant interviewing and sampling are seen as narrow and inadequate. He contends that research should be flexible, and should select a range of methods that are appropriate to the research problem. McCracken (1988) suggests using archival data, observation, focus groups, and/or learning journals to triangulate with the interview.

However, Bryman (1992) stresses that a combination of quantitative and qualitative data is not the same as mixing quantitative and qualitative research, because the data are derived from the same instrument, and not from different methods of data collection. The inclusion of open-ended questions in some structured interviews is itself quantitative in nature. Jick (1979) concludes that the use of triangulation may not necessarily be suitable for all purposes, but it can heighten the importance of qualitative methods in research, and at the same time demonstrates that the quantitative methods can and should be used in complementary fashion.

5.5 TECHNIQUES OF COLLECTION

The theoretical underpinning sets the groundwork for the way in which the research method is to be employed. Understanding the techniques of collecting data is also a central issue in the consideration of an appropriate research design. Some of the commonly used techniques are interview, questionnaire survey, observation, and experiment (Sommer & Sommer, 1980). The interview and questionnaire survey are very efficient with opinions and attitudes, observation is well suited for studying people and events at first hand in natural settings, while the experiment focuses on phenomena under controlled conditions to establish causal relationships (Brewer & Hunter, 1989).

Sommer & Sommer (1980) have also given some guidelines for selecting the appropriate collection techniques, as presented in Table 5.1 below:

Table 5.1 Choosing Data Collection Technique

	PROBLEM	TECHNIQUE
1.	To obtain reliable information under controlled condition	Experiment/simulation
2.	To find out how people think	Observation
3.	To learn what people think	Questionnaire survey/ interview
4.	To understand an unusual event	Case study

Source: Sommer & Sommer (1980)

Prior research on the lending decision process of bankers has been conducted using a number of techniques, such as survey and postal questionnaire (Ulrich & Cassel, 1974; Memon, 1984, Fay & William, 1993), a combination of survey and interview (Barona, 1985; Vyakarnam & Jacobs, 1991), and qualitative interviews (Stephens, 1980; Berry et al, 1993; Berry, Crum & Waring, 1993; Deakins & Hussein, 1994; Fletcher, 1995). However, it is often argued that the use of survey and postal questionnaires does not allow an in-depth exploration of particular issue (Read, 1998), which is essential to reveal the underlying caused mechanism and structures that lie behind observed behaviour, the main aim of this study. Furthermore, the postal and survey questionnaires are renowned for their lower response, the fact that they are not always completed fully or with care, and respondent bias (Owens, 1986).

Therefore, recent researchers have not only identified the paucity of the qualitative approach in undertaking research on understanding the lending decisions on small business, but also recognise the need to give an in-depth insight into the decision-making process and for the situation to be as near as possible to the actual bank lending. Based on these arguments, the interview technique seems particularly appropriate for the study of lending decisions since it permits the acquisition of valuable anecdotal information. The studying of the process of making a decision requires detailed descriptions, and experiences which vary among different people. Furthermore, the decision-making itself is fluid and dynamic, and participants' perceptions are thus a key to a process consideration. Hirshman (1986), in an article on the marketing decision-making process, suggests that in a study which involves human beliefs, behaviours, perceptions and values, the most appropriate methods are observations and interviews. It should also be stressed that the choice of research design must be linked to the subject under investigation, and the objectives being pursued within the practical constraints of location, time and cost (Hakim, 1986).

5.5.1 Interviews

Interviews are well suited to a study of perceptions and decision-making. The techniques allow the participants to describe their perceptions, and also allow the researcher to question the participants directly about how they understand their decision. Salkind (1997) argues that interviews are helpful to get at information that might otherwise be difficult to come by, including first-hand knowledge of people's feelings and perceptions. Interviews also offer great flexibility in letting the researcher go in any direction (within the scope of the research) with the questions. The researcher can also note the interviewee's non-verbal behaviour, the setting, and other information that might prove valuable. Furthermore, the researcher can set the tone and agenda at his or her own convenience.

Interviews can range from highly structured to unstructured interactions. Some of the classifications, according to Sommer & Sommer (1980), are:

1. Structured interview

The questions in the interview are formulated beforehand, and asked in a set order and in a specified manner. No divergence from the questions is permitted, nor can the order in which they are presented be altered. The responses have to be recorded within the criteria given. The theory behind this structured interview is that each person is asked the same question in the same way, so that any differences between answers are held to be real ones and not the result of the interview situation itself (May, 1997).

The structured interview has the benefit of providing as much control as possible over the interview, thereby curtailing the directions in which the interview can proceed. This eases the problems of recording the respondents' replies, and it helps in the interpretation of the results. It also reduces biases, as all interviews are conducted within the same limits.

2. Unstructured interview

The main goals of this interview are to explore all the alternatives in order to pick up information and define areas of importance that might not have been thought of ahead of time, and to allow the respondent to take the lead to a greater extent. The interviewer has in mind a general topic and may want to ask specific questions. However, there is no predetermined order or specified wordings to the questions.

This interview concept was formulated by Rogers (1945) who first used it in counseling and psychotherapy, and later commented that it was useful in research interviewing as a means of avoiding response biases. However, there are a number of disadvantages in using this technique (Proctor & Stone, 1978). The interview is extremely difficult to control and requires experienced interviewers if it is to be conducted effectively. Considerable skill may be needed to return the discussion to the specified field, and the duration of the interview may vary substantially. The accurate reporting of the respondents' comments can also be very demanding.

The term 'in-depth interview' is also used to describe the unstructured interview. It was defined by Karpf (1953) as an investigation which deliberately aims to elicit unconscious as well as other types of material relating especially to personality dynamics and motivations. The interview is generally a lengthy procedure designed to encourage free expression of affectively-charged information. It may be used in conjunction with special devices such as free association and projective techniques. When skillfully and cautiously used by an interviewer having specialised training, the in-depth interview can reveal important aspects of psycho-social situations which are otherwise not readily available, and yet may be crucial for understanding observed behaviour and reported opinions and attitudes.

Paget (1983) views the in-depth interview as a scientific means of developing systematic knowledge about subject experience. She sees it as a medium through which the interviewer and interviewee jointly create this knowledge, where the former is fully implicated in the process of gaining knowledge about the interviewee's subjective experience. However, the disadvantages of using the in-depth interview are the greater time and costs involved in carrying out the interview, and also in absorbing and analysing the scripts.

3. Semi-structured interview

Under this technique, the questions are normally specified, but the interviewer is much freer to probe beyond the answers in a manner that would appear prejudicial to the aims of standardisation and comparability. It enables the interviewer to have more latitude by this probing beyond the answers, and thus to enter into a dialogue with the interviewee (May, 1997).

This technique is also called the focused interview (Holloway, 1997). Developed by Merton and Kendall (1956), the interview is unstructured in the sense that the wording of questions is not specified. The interviewer here prepares a list of topics based on his previous definition of the problem and understanding of the phenomena under investigation. But the manner in which questions are asked, and their timing, are left largely to the interviewer's discretion. He has freedom to explore reasons and motives, to probe further in directions that were unanticipated. Although the respondent is free to express completely his own line of thought, the direction of the interview is clearly in the hands of the interviewer. He wants definite types of information, and part of his task is to confine the respondent to discussion of the issues about which he wants knowledge. May (1997) argues that the focused interview allows the meanings that individuals attribute to events and relationships to be understood on their own terms. It therefore provides a greater understanding of the subject's point of view.

Meanwhile, Patton (1990) describes three variations in qualitative interviewing. The first type is the informal conversational interview, which relies entirely on the spontaneous generation of questions in the natural flow of interactions. The actual wording of questions is not determined in advance. The general interview guide approach is the second type. This interview provides a general checklist so all relevant topics are covered. It presumes that there is common information that should be obtained from each person interviewed, but no set of standardised questions is written in advance. The third type is the standardised open-ended interview. It consists of a set of questions carefully worded and arranged with the intention of taking each respondent through the same sequence and using with each respondent essentially the same words.

The characteristics, strengths and weaknesses of these three variations are presented in Table 5.2 below:

Table 5.2 Variations of Qualitative Interview

Type of interview	Characteristics	Strengths	Weaknesses
Informal conversational interview	Questions emerge from immediate context and are asked in natural course of things; no predetermination of question topics or wording.	Increases salience and relevance of questions; interviews are built on and emerge from observations; interview can be matched to individuals and circumstances.	Different information collected from different people with different questions. Less systematic and comprehensive if certain questions do not arise naturally.
Interview guide approach	Topics and issues to be covered specified in advance, in outline form; interviewer decides sequence and wording of questions in course of interview.	Outline increases comprehensiveness of data and makes data collection somewhat systematic for each respondent. Logical gaps in data can be anticipated and closed. Interviews remain fairly conversational and situational.	Important and salient topics may be inadvertently omitted. Interviewer flexibility in sequencing and wording questions can result in substantially different responses from different perspectives, thus reducing comparability of responses.
Standardised open-ended interview	Exact wording and sequence of questions determined in advance. All interviewees asked same basic questions in same order. Questions worded in completely open-ended format	Respondents answer same questions, thus increasing comparabi-lity of responses; data complete for each person on topics addressed in interview.	Little flexibility in relating interview to particular individuals and circumstances; standardised wording of questions may constrain and limit naturalness and relevance of questions and answers.

Source: Patton (1990).

5.6 CHOICE AND RATIONALE OF RESEARCH DESIGN

As stated in the earlier section of this chapter, the selection of a research design for this study should be based on the need to have an in-depth understanding of the bank's lending decision on small businesses. The researcher had also mentioned the interview as the most likely technique for studying the lending decision process. Therefore, in meeting this objective, a combination of an interview guide and a standard open-ended approach of a qualitative interview, as suggested by Patton (1990), seems to be the most appropriate method to collect the required information. Patton (1990) also argues that this approach provides the interviewer with precisely worded questions in a predetermined fashion, while permitting him or her more flexibility in determining when it is appropriate to explore certain subjects in greater depth, or even to undertake whole new areas of inquiry that were not planned earlier. Furthermore, the researcher can examine the same issues from a number of perspectives, thereby increasing confidence in the validity and credibility of the findings (Denzin, 1978; Jick, 1979; Mathison, 1988).

The rationale for choosing the interview technique is also supported by Banister et al (1994), who give the four main reasons. They are:

1. An interview is concerned with subjective meanings rather than with eliciting responses within a standard format.
2. Interviews can permit exploration of issues that may be too complex to investigate through quantitative means.

3. Conducting interviews is a salutary lesson in research involvement and practice. An interviewer is forced to confront his or her own participation within the research.
4. An interview is associated with the process of making visible the researcher's work in the construction of the material, and thus with the question of power relations in research.

However, Brookfield (1987), McCracken (1988) and Patton (1988) advise caution when using this interview technique. They point out that interviewing is a very difficult task, requiring a great deal of skill. Brookfield (1987) believes that it is the data collection method most open to abuse.

Patton (1988) put across this message:

"Interviews are a limited source of data because participants and staff can only report their perceptions of, and perspectives on what has happened. These perspectives and perceptions are subject to distortions due to personal bias, anger, anxiety, politics, and simple lack of awareness. Interview data can be greatly affected by the emotional state of the interviewee at the time the interview takes place. Interview data are also subject to recall error, reactivity of the interviewee to the interviewer, and self-serving responses".

In choosing the research method, it should also be emphasised that the motivating factor that underlies this study is that, despite a number of studies having been conducted on bank lending decisions on small businesses, there was a lack of similar research in the developing countries. It was also mentioned that there was a paucity of qualitative research in areas of small business lending decisions. Therefore, it is most appropriate at this juncture to discuss in detail the qualitative methods employed in previous studies, to justify the technique to be used in this study.

A number of studies adopted a ' protocol analysis' technique in understanding the lending decisions of bankers. This technique consists of verbalisation of mental activities and observations of other activities by decision-makers during the problem solving. By employing the protocol technique, researchers are interested in how complex judgements and decisions are made. They also seek answers to questions such as what information in the task environment decision-makers acquire, how they use that information, what knowledge they bring to the task, how that knowledge is organised, and what is the structure of the overall decision process (Biggs et al, 1993). Berry et al (1993a), for example, used open-ended interviews with bank managers to understand actual practices in lending decisions. The interviews were unstructured in that the bank managers were simply asked to 'talk about' their lending decisions, and the researchers took on the active role of describing situations in their own ways. The bank managers were asked to discuss up to six real cases, including successful and unsuccessful applications, new businesses and new customers, and existing businesses and existing customers.

Berry, Crum and Waring (1993) employed both the interview technique and case studies to understand the bank decisions on lending to corporate customers. The aim of this study was to establish as far as possible the actual processes in the loan assessment. Initially, the bank officers who were directly involved in lending to corporate clients and had their own discretionary limits were interviewed. Later, a sub-sample of these officers was selected for the case studies. They were then given a small set of case studies and were instructed to process them just as if they were the actual data from the business applicant. However, the results of the case study analysis were not integrated with those arising from the interviews. These researchers believe that the case studies provide details of the analytical process actually applied in dealing with a loan application, which could not be generated in interview. They argue that interviews can indicate 'what' is done, but the case studies show 'how' things are done.

In another study, Stephens (1980) employed a combination of Delphi Alpha and protocol analysis techniques to understand the lending decision process of bank lending officers. However, Stephens used the protocols to test what was discovered in the Delphi study, and to further define and illuminate the Delphi results for the behaviour observed in the study. Twelve bank officers from six different banks were given a set of financial statements as instruments to be used in gathering the protocols. The analyses of use of information by the bankers en route to their lending decisions were performed on these twelve officers.

However, the drawback of the protocol technique found in the study by Berry et al (1993a) is that, the bank managers were placed in a position to choose propositions they had already made decisions upon. This would enable the managers to hide mistakes (Philpott, 1994). In addition, the technique was focused mainly on the financial aspect of information required in the lending assessment, and the managerial information was lacking (Deakins & Hussein, 1994). For a new business there is no track record of financial information which may be used for assessment, such as profitability, liquidity or sales growth. Therefore, bankers were expected to place more emphasis on the abilities and experience of the entrepreneur. Similarly, studies by Berry, Crum and Waring (1993), and Stephens (1980) also focused mainly on the use of accounting information in the bank's lending decisions. Furthermore, using the protocol technique may also raise the question of its validity (Anderson, 1985; Boritz, 1986; Russo et al, 1989). It is argued that respondents may alter their decision processes when thinking aloud, and that respondents' verbalisation may not be a complete trace of the processes actually performed (Biggs et al, 1993).

Another method of study on the lending decision is by Vyakarnam and Jacobs (1991). The researchers focused on how bank managers construe high technology entrepreneurs, and it was carried out through a structured interview using a 'repertory grid technique' (Kelly, 1955). This technique asserts that the ways in which people perceive situations are the primary influence on their behaviour. The technique involves the use of a tightly structured interview in which a systematic comparison of elements enables the respondents to identify 'constructs', that is, the ways he or she has of making sense, or construing the element. Constructs are frequently expressions of feelings and perceptions, which the individual uses as a guide to action, without necessarily having verbalised them explicitly prior to the interview. In this study, the bank managers were asked to think of nine of their clients who fitted the descriptions of best, worst, organised, successful, and so on. They were then asked to describe similarities and differences between these clients, using a three-card structured interview. This technique helps to understand the attributes that influence these managers in their decision-making. The interview was followed by a mail survey, where structured questionnaires were sent to the bank managers asking them to rate their views on high technology entrepreneurs, using a seven-point scale. However, it is argued that this technique would only produced superficial data (Berry et al, 1993), and that the people's perceptions on the situations which influence their behaviour may not necessarily be accurate (Jankowich & Hisrich, 1987).

Another approach to studying the lending decision process is one adopted by Deakins and Hussain (1994). In this study, the researchers used a real standardised business plan for a start-up venture. They became the interviewees, taking the role of the entrepreneurs and recording the bank managers' questions and comments on the business plan. The managers were also asked structured questions on the importance of general criteria for assessing decisions on lending to small businesses. Fletcher (1995) adopted a similar study on decisions on lending to small firms in Scotland. The bank managers were asked to evaluate the business proposition under conditions as near as possible to a realistic lending situation. Each bank manager was sent in advance a business plan, based on the proposal. The researcher took on the role of an entrepreneur and was interviewed as a potential client. The interviews were recorded and transcribed. The process of decision-making was recorded through the questions asked by the bank managers, their responses to the answers given, and the funding decision which resulted. However, this technique was also criticised because it did not reflect the variety of lending propositions the banker may encounter in a real situation (Berry et al, 1993). Furthermore, the studies lacked the 'contextual' approach in understanding the lending decisions of bankers. It is argued that the 'context' of bankers such as occupational, social and educational experiences as well as their perceptions and expectations also play a major role in the funding decisions

(Sargent & Young, 1991). In addition, the influence of heuristic judgement in the lending decision should not be ignored (Jankowich & Hisrich, 1987).

The approach of this study is similar to the work of Deakins & Hussein (1994) and Fletcher (1995). As in those studies, the lending decision is analysed using a real standardised business plan through an in-depth face-to-face interview with the bankers. Furthermore, the business plan was for a new venture. This is also one of the main reasons for the researcher not to employ the 'protocol analysis' in the study because it entails the use of past or historical data. However, this study also differs from the earlier research in a number of ways. First, this study attempts to explore beyond the boundaries of present research by including the social and psychological aspects in the lending decision process. Second, the proposition was the researcher's own version of a 'real' business plan modified to suit the local environment. The manner in which the plan was presented, the method of scoring and how the decision was made (to accept/reject or to defer) were entirely those of the researcher. Furthermore, the plan was modified from a real business plan that was successfully used in obtaining the bank loan. Thirdly, the criteria used in the questionnaire were adapted from a variety of literature, and they were employed as a separate method in collecting data. The idea was to have a broader and better understanding of a bank's lending decision by looking from two different perspectives.

As mentioned earlier, there was no prior research on bank lending decision on small businesses being conducted in Malaysia, and any form of such research will be exploratory in nature. By adopting a more holistic approach which acknowledges the influence of social and psychological factors in the lending decisions, a valuable framework is created in understanding the process of bank managers' decision-making on lending to small businesses in Malaysia. This technique also allows for an 'understanding' of human behaviour and experience that can be explored, interpreted and presented in rich, detailed descriptions (Heath, 1991; Crabtree & Miller, 1992).

5.7 SAMPLING CHOICE

Choosing the right sample is always crucial to the success of any research. The quality and credibility of a sample must be judged in terms of the research design employed in collecting the data. In quantitative research, respondents selected at random have to be established as representative of a wider population so that the generalisability of findings can be enhanced (Smith, 1975; Bryman, 1988). Generalisability refers to the scope of applicability of the research findings from one setting to other settings. Since sampling error will be smaller with large samples, the probability is that measurements made on the sample will reflect the true value in the population, and it will improve with increasing sample size (Kelle & Laurie, 1995).

However, in qualitative studies, researchers are not concerned with large sample sizes since the methodology does not entail concepts like statistical generalisability or statistical sampling error. They usually work with small samples of people nested in their context and studied in-depth (Miles & Huberman, 1994). Burgess (1984) points out that qualitative researchers may not simply sample people but also activities, time periods, and locations.

Generally, sampling can be divided into two broad classes (Singleton, Straits & Straits, 1993). These are:

1. Probability sampling

Its essential characteristic is that all cases in the population have a known probability of being included in the sample. It includes simple random sampling, stratified random sampling, cluster sampling, and systematic sampling. In simple random sampling, random selection from the entire population makes it equally possible to draw any combination of cases. In stratified random sampling, the population is divided into strata, and independent random samples are drawn from each stratum. In cluster sampling, the population is divided into natural groupings or areas called clusters, and a random sample of clusters is drawn. Systematic sampling, which often provides a reasonable approximation to simple random sampling, consists of selecting cases from an available list at a fixed interval after a random start.

2. Non-probability sampling

The chances of selecting any case are not known because cases are randomly selected. It includes convenience, purposive, and quota sampling. Convenience sampling is where a researcher selects a requisite number of cases that are conveniently available, and that may not offer any basis for generalising. Purposive sampling involves the careful selection of typical cases or of cases that represent relevant dimensions of the population. Quota sampling allocates quotas of cases for various strata, and then allows for non-random selection of cases to fill the quota.

Singleton, Straits & Straits (1993) also suggest the three factors that may influence the choice of sampling design. These are: (a) the stage of research and data use, with research in later stages intended to provide accurate population descriptions requiring the most sophisticated probability sampling designs, and in the case of exploratory phases of research in which accuracy is least important and generalising is irrelevant, convenience or purposive sampling is appropriate, (b) available resources, such as time, money and personnel, and (c) the method of data collection, where convenience sampling is the rule in experiments, probability sampling is found in most surveys, and purposive sampling typifies field research.

Taking into consideration the above factors and the nature of the research approach adopted in this study, the sampling design chosen was a mixture of purposive and probability sampling. This was to ensure that the sample covers the range of differences that characterise the phenomena being studied. Purposive sampling is obtaining information from specific people who will be able to provide the desired information, either because they are the only ones who can provide the needed information, or because they conform to some criteria set by the researcher. On the other hand, probability sampling ensures that elements in the population under study have some known chance of being selected as a sample (Sekaran, 1992).

The use of purposive random sampling has also been advocated by Patton (1990). He argues that the small sample size normally associated with qualitative research does not automatically mean that the sampling should not be random. He contends that random sampling, even for small samples, will substantially increase the credibility of results. A small purposive random sample aims to reduce suspicion about why certain cases were selected for study, but such a sample still does not permit statistical generalisation. Other researchers, such as Morse (1989), Kuzel (1992) and Oppenheim (1992), also argue on purposive random sampling for qualitative research. Oppenheim (1992) believes that a researcher will need a good spread of respondent characteristics so that he or she can reasonably hope to have tapped probable respondents of every kind and background. However, Morse (1989) and Kuzel (1992) point out the need to set boundaries and define aspects that can be studied within the limits of a researcher's time and means.

How to determine the sample size? According to Patton (1990), there are no rules for sample size in qualitative research. Sample size depends on what a researcher wants to know, the purpose of the inquiry, what is at stake, what will be useful, what will have credibility, and what can be done with available time and resources. The Social and Community Planning Research, for example, comes out with a sample size of between 20 to 30 for the in-depth interview, because of the greater time and costs involved in carrying out such an interview, and in absorbing and analysing the scripts (SCPR, 1972). Roscoe (1975) proposes a number of not less than 30 as an appropriate sample size for most research.

Glaser & Strauss (1967) argue that a qualitative researcher should give less attention to the need to meet statistical sampling in assessing the adequacy of a sample. He or she should rather be more concerned with the issue of whether the sample conforms to the researcher's emerging theoretical framework. Mason (1996) contends that when purposive sampling is used, the question of whether or not the sample size is statistically representative of a population does not arise.

However, Kelle & Laurie (1995) believe that increasing the sample sizes in qualitative research may have a positive effect for a number of reasons. Multiple comparisons between purposefully selected cases are crucial to identify patterns and to develop theoretical categories. An increase in sample size may add greater breadth to the scope of analysis while maintaining the depth of interpretation, which can be regarded as the hallmark of qualitative analysis techniques.

Given that the sampling design has been considered, the sample size should therefore reflect what the researcher wants to find out, why the researcher wants to find it out, how the findings will be used, and what resources are available for the study. Lincoln & Guba (1985) recommend a sample selection to the point of redundancy. They state that:

"In purposive sampling the size of the sample is determined by informational considerations. If the purpose is to maximise information, the sampling is terminated when no new information is forthcoming from new sampled units, thus redundancy is the primary consideration".

Therefore, to meet the objective of this study, a sample of between 35 and 40 respondents was anticipated. This number was also based on experiences of past researchers in similar research on bank lending decisions. Some of these researches are reviewed and presented below.

Yavas et al (1990) interviewed 30 senior bankers to gain understanding of strategies employed by Kuwaiti banks in meeting the challenges facing the industry. Holland (1993), who studied the concepts of bank-corporate relationships, obtained 15 firms and 10 banks as sample size. He suggests that in ideal conditions, in-depth interviews of that size would clearly have an impact on the research objective. Philpott (1995) obtained 23 respondents for face-to-face semi-structured interviews. He argues that the sample size is a reflection of the methodological approach taken. Berry et al (1993a) used 63 bank mangers for unstructured interviews, while Berry, Crum & Waring (1993) interviewed 21 bank officers to study lending decisions. Deakins & Hussain (1994) used a sample size of 30 bank managers, and Fletcher (1995) obtained access to 38 bank managers in Scotland who were active in small business experiences.

5.8 ISSUES OF VALIDITY AND RELIABILITY

Not surprisingly, the issue of validity and reliability of the research design is also hotly argued among the qualitative and quantitative researchers. According to Kirk & Miller (1986), the language of validity and reliability was originally developed for use in quantitative science. Most of the researchers, then, devoted their time on validity issues to the generalisability of findings. Quantitative researchers are concerned with whether the study describes what is really there, and the instrument used in the study measures what it is supposed to measure (Merriam, 1988; Patton, 1990; King, 1994). Reliability, on the other hand, is concerned with whether the researcher can be trusted as the instrument of collection, and whether the technique used consistently solicits the same kind of data each time it is used (Merriam, 1988). A reliability test can measure the same thing more than once and will result in the same outcome (Salkind, 1997).

Kirk & Miller (1986) and Silverman (1993) argue that validity and reliability are of utmost importance because in them the objectivity of scientific research is at stake. Perakyla (1997) also argues that in research practice, enhancing objectivity is a very concrete activity. It involves effort to assure the accuracy and inclusiveness of recordings that the research is based on, as well as efforts to test the truthfulness of the analytic claims that are being made about those recordings.

However, the underlying issue has received only scant attention from the qualitative community. Some strongly reject generalisation as a research goal (Denzin, 1983), while others give it very low priority, or see it as essentially irrelevant to their goals (Smith, 1984). A widely shared view among them is that it is unimportant, unachievable, or both (Schofield, 1994).

Nevertheless, Easterby-Smith, Thorpe and Lowe (1991) argue that if a researcher is committed to providing a faithful description of others' understandings and perceptions, then ideas such as validity and reliability can provide a very useful discipline. Furthermore, it can be used to minimise errors or biases in a study (Yin, 1989). King (1994) contends that the concept of validity and reliability is the same in both research traditions. In quantitative research, the notions of validity centre on methods, while in qualitative research the concern is for the validity of interpretations.

Similarly, the same yardstick of reliability applies to qualitative research, where measures used with the same individual should yield the same value from moment to moment.

Meanwhile, Miller (1992) and Merriam (1988) suggest the use of triangulation or multiple methods of data collection and analysis for strengthening validity as well as reliability in research. Silverman (1985) emphasises the employment of quantitative information in a qualitative research as a means of establishing the generalisability of the observations. Others, like Heineman (1989) and Taylor (1993) believe that familiarity with the subject matter enhances the researcher's work, while Eisner (1991) and Lincoln & Guba (1985) seek believability based on coherence, insight, and instrumental utility and trustworthiness through a process of verification, rather than through traditional validity and reliability measures.

For this study, the researcher is using an interview technique, and therefore there are elements of quantitative and qualitative approaches being used to collect the data. The quantitative instruments may need to undergo some statistical testing to determine their stability and consistency in measuring the phenomena. However, for collecting qualitative information, the researcher has used some conventions applied in the qualitative fields (Kirk, 1986; Merriam, 1988). The conventions for reliability include (a) describing clearly how and why the researcher selects the problem for study, (b) explaining why the problem is a problem and worthy of study, (c) revealing how and why the methodology and samples are chosen, (d) exposing the researcher's assumptions to determine how these might affect the study, and (e) using data from the study to support each conclusion drawn from the study. The conventions of validity require that the structure and design of the study fit the problem. In other words, the study must clearly define whom the findings relate to, and the information collected must serve the purpose of expanding the understanding of the study question. Guba & Lincoln (1981) and Patton (1990) also suggest that validity in qualitative inquiry hinges to a great extent on the skill, competence and rigour of the researcher. As commented by Guba & Lincoln (1981):

"Since as often as not the naturalistic inquirer is himself the instrument, and ..., as well as variations resulting from differences in training, skill and experience among different "instruments", easily occur. But this loss in rigour is more than offset by the flexibility, insight and ability to build on tacit knowledge that is the peculiar province of the human instrument".

5.9 PROCESS OF DATA COLLECTION

The careful description of the data collection process is important for describing, clarifying and understanding the development of the entire research. Determining the sample is the first step towards this process. This study concerns the process of decision-making of bank managers on small business propositions in Malaysia, and the most reliable source of information is the bank managers at the branch level. The banks chosen for this study are the commercial banks, the largest financial institutions, with a wide network of branches in the country. As explained in Chapter Two, commercial banks are distinct from other financial institutions, in that they are the only institutions licensed by the central bank (Bank Negara Malaysia or BNM) to operate current or checking accounts and provide overdraft facilities. Furthermore, they are the institutions entrusted by the authorities to channel most of the funds to the small business sector.

The respondents for this study consist of 40 bank branch managers purposively and randomly selected from the states of Kedah, Perlis, Penang, Kelantan and Terengganu. These states are located in the northern parts of Peninsular Malaysia. The criteria for selection were that the participant was in the top position at the branch, the banks had a network of branches nationwide including the rural areas, and the banks had special units to cater for small business customers. It was assumed that this level of respondents would be most familiar and knowledgeable about the issues under study. For these reasons, the researcher has limited the investigation to a selected number of locally-owned banks only. The researcher also chose the northern parts of the Peninsular because of the nature of the research design, coupled with the time and cost constraints. Furthermore, the majority of the businesses found in these states were classified as 'small'. There were no official statistics of bank branches classified within the criteria in these five states, but the researcher strongly believes that the figures did not exceed 200 branches. Therefore, the sample size of 40 respondents is considered adequate to serve the purpose of the study, given the nature of the research design employed.

After the sampling criteria were determined, the researcher sent official letters to the Chief Executive Officers (CEOs) of six major banks in Malaysia asking their permission to conduct the study among their respective branch managers (See Appendix A). These six banks were earlier identified according to the criteria established. The head office's permission was absolutely necessary because the banking industry is subject to the secrecy rule, and any information revealed must be strictly guided by and adhere to this rule. Three of the CEOs gave positive responses, while another gave a conditional approval subject to the researcher seeing him first, and discussing the contents of the proposed interview, which the researcher complied with in Malaysia. The other two CEOs did not reply. The researcher later learned that they were too pre-occupied with the financial crisis that had severely affected their banks. Therefore, the researcher made no effort to follow-up with them.

The interviews were conducted between the months of April and August 1998 when the researcher was in Malaysia. The branch managers of banks identified were first contacted by telephone, and asked whether they would be willing to participate in the study. Some of them had in fact been informed in advance by their head office of the CEOs' decisions. Those who indicated their willingness to participate were then scheduled for interview. Due to the nature of questions planned for the interview, the questionnaire was sent in advance to be read and understood, and partly completed prior to the interview. These branch managers were asked to fill in details about their biographical data, besides allowing them time to peruse the materials.

The questions in the interviews were both semi-structured and open-ended in nature, and were conducted with the aid of a questionnaire guide (See Appendix B). The questionnaire aid was necessary to prevent the discussions from becoming incoherent. Some of the structured items were established in advance from existing literature and previous research. The questionnaire itself was constructed after a series of discussions with an entrepreneur and bank officials. It was also pilot-tested with two bank managers. These pilot interviews served to minimise the researcher's anxiety

(Berg & Smith, 1985), and alerted the researcher to questions that may introduce sensitive topics. The awareness of the potential for exposing difficult and sensitive issues for the respondents was central to successfully conducting these interviews (Handler, 1989).

The questionnaire had two main components. The first consisted of a real business proposition for a new venture. It was designed in such a way that the researcher became the interviewee and the respondent, the interviewer. The researcher took the role of a small business entrepreneur applying for a bank loan, and was interviewed by the bank manager. The bank manager was given complete freedom to question the researcher on the proposition, to express his or her views and comments, and to decide whether to accept or reject the loan application. The manager was also asked to provide reasons for his or her decisions. To complement these decisions, the manager was asked to provide a score on the proposition based on a ten-point scale. The use of scoring points was to ensure consistency in the analysis of the lending decisions. In similar studies by Deakins & Hussain (1994) and Fletcher (1995), the scoring was done by the researchers themselves who based it on certain criteria as decisions by the bankers. However, for this study the managers were asked to provide the scores for the purpose of finding their overall perceptions on the proposition. Furthermore, the researcher would not want to bias the findings since the researcher himself had no expertise in the field. All questions asked by the manager, and his or her responses to answers given in the interview, were recorded or noted, and transcribed. It has been argued that this approach to the interview is the best way to observe the actual decision-making process of the bank managers, and to obtain the required information for the study (Deakins & Hussain, 1994; Fletcher, 1995).

The business plan used was a real business venture obtained from an entrepreneur in Malaysia, but was modified to suit the objective of this research (See Appendix C). The plan was modified because the original amount involved a sum that would not fit into a "small business" category of the study. Furthermore, the amount was beyond the approval discretion of most bank managers at the branch level.

The researcher also decided to use this business plan for a number of reasons. Firstly, the researcher was familiar with it because the researcher himself was involved in drafting the original plan with the entrepreneur. Secondly, the plan was used successfully to obtain a bank loan after being rejected previously by two other banks. Hence, it had undergone a rigorous test in the decision-making process by the bankers. Thirdly, the booming construction industry in the late-1980s and 1990s became a catalyst for the growth of related industries such as in the consultancy field. Thus, the type of business in the plan typified the proliferation of new ventures during those periods. Fourthly, the Malaysian government has encouraged the establishment of new colleges and institutions to cater for the growing needs of available places at tertiary level. Thus, any business activities related to education were categorised as "productive sector" by the central bank, and should be given priority by the banks when applying for the loans. Finally, the business plan also typified the nature of the small businesses being developed by the government through the vendor programme. Under this programme, new ventures were created to supply the required parts to big corporations which acted as their anchors. Although the business seemed to be secured because of an assured market for the product or products, it has its own element of risk such as default payment or economic downturn. Thus, this business plan which typified the reality of a small business in Malaysia at the time of study was the most appropriate proposition used for understanding the lending decisions of bankers on small businesses.

The plan here was for a management consultancy business, and the projected cash flow and profit and loss statements were shown. The researcher, acting as an entrepreneur, was seeking to raise RM200,000 loan from the bank, while having an equity capital of RM100,000. The gearing ratio for the proposed venture was 2:1. In actual bank funding, it is argued that the owner's contribution should not be less than 60 per cent of total cost of the venture, but a contribution of 40 per cent is considered sufficient in a hypothetical situation (Fay & William, 1993). Deakins & Hussein (1994) also argue that because of asymmetry of information, bankers in England would require all new ventures to be supported with collateral when applying for loans. However, Fletcher (1995) in a similar study in Scotland found that bankers there were more prepared to back the proposition without security. These bankers have developed risk assessment strategies which do not rely on security. In this study, the business plan was prepared in such a way that it could be 'secured' or 'unsecured', depending on how the bankers perceived it. Since the venture was based on a guaranteed stream of income for the duration of the contract, the security could be in the form of 'reassignment' of rental directly to the banks. However, no other assets have been pledged as collateral for the proposition.

The second component of the questionnaire contained a list of factors considered important in assessing small business loan propositions, both for new ventures and existing small businesses. The manager was asked to rate the relative importance of these factors on a 5-point scale ranging from "great importance" to "unimportance". These factors were adapted from selection criteria mentioned in previous research, especially those of Ulrich & Cassel (1974), Ulrich & Arlow (1981), Memon (1984) and Deakins & Hussein (1994), personal experience, and interviews with bank officials. The 5-point scale was used for comparative purposes.

In the interview the manager was also asked to discuss his or her opinions, attitudes and perceptions on some of the issues relating to decisions on lending to the small business sector. The questions were open-ended in nature, and probing was used to extract details of the answers. Finally, a section of the questionnaire was designed to collect relevant demographic information from each bank manager.

Although it was quite difficult to put together a schedule for interviews with the 'always busy' respondents, the researcher managed to achieve the targeted 40 bank branch managers during the five-month fieldwork in Malaysia. The researcher was also quite surprised at the ease of access to some of these managers once the interview had been arranged. Three of the managers took this study seriously, and even had some brainstorming sessions with their credit officers prior to the interviews. Some asked for more time so that they could carefully study the business propositions. However, it was also felt that there might have been pressure on some of them to be involved, and they had to oblige because of directives from the head office. But the researcher made a point of confirming with them that they were happy to be interviewed, making clear that no one would know if they were not. When the researcher explained the purpose of this research and assured them of confidentiality, all of them agreed to continue. The average length of the interview was between one and a half-hour and two hours each. However, in some cases, the meetings lasted up to three hours.

It was suggested that the interviews were tape-recorded to ensure that none of the important points was missed. Tape-recording is also now the norm in the interview as a technique in data collection. The purpose of conducting the interviews in this manner was to ensure the capture of as much data as possible from a particular case. This would then allow a better understanding of the various contextual factors that might impinge upon the issues being investigated. However, the researcher found that a large number of the respondents refused to be tape-recorded, and only eighteen of them agreed, but not without some hesitations. This led the researcher to discard this technique for those respondents who felt uncomfortable, and the interview proceeded with the aid of note taking. Although note taking could result in the loss of some of the respondent's own words, the researcher made an effort to keep them as exactly as the technique of recording permitted. The researcher also believes that the reluctance to be tape-recorded was due to the nature of the industry, where business is normally transacted in a strictly private and confidential manner. It may also be due to the culture of 'not to be quoted' among the bank managers. This concurs with the argument put forward by Oppenheim (1992) that the suspicions among respondents in the developing countries are very much higher compared to industrialised nations, where most respondents would be familiar with recorders and readily give their consent when politely asked, "Do you mind if I tape our conversation?"

The researcher also took serious efforts to minimise or eliminate the possibility of biases in the interview. Some of these biases could be attributed to a number of factors (Sekaran, 1992; Holloway, 1997). The interviewer can contribute to the biases of data collected if proper trust and rapport are not established with the interviewee, or when the responses are either misrepresented or distorted, or when the interviewer intentionally encourages or discourages certain types of responses through gestures, facial expressions, and so on. On the other hand, the interviewees can bias the data when they do not give their true opinions but provide information that they think is what the interviewer is expecting or wants to hear or would like. Also, if the interviewee does not understand the questions, he or she may feel hesitant to ask for clarification. Therefore, one of the strategies adopted by the researcher to reduce these biases was to leave sensitive or more complex issues until rapport and trust have been established. Establishing a relationship with the respondents is considered an utmost important strategy in determining the quality of data. Measor (1985) suggests that the interviewer should interact with the person being interviewed, 'entering another person's world' and their perspectives, and use shared interests to stimulate rapport, while Brookfield (1987) urges sharing personal experience of the interviewer with the interviewee. Measor further argues that to ensure that an interview can be successfully conducted, there is a need to retain a critical awareness of what is being said, and to be ready to explore some issues in great depth, or by listening beyond.

In these interviews, although the respondents were senior executives, held top positions at the branch and the interviews were conducted at their own offices, the researcher still felt it necessary to put them at ease. The interview began with simple questions which the respondents could answer easily and without potential embarrassment or distress. As the interview progressed, the researcher realised that a conducive environment encouraged the respondents to view the interviewer as an interested observer in whom they could confide their thoughts. It appeared that some of the respondents were initially uncomfortable because of what they perceived as the researcher being 'knowledgeable' in the field and a 'friend' of their bosses.

The researcher also adopted the three conditions outlined by Moser & Kalton (1983) for the success of interviews. These are:

1. The interviewee must have access to the information which the interviewer seeks.

2. The interviewee must understand what information is required, and also understand what is expected of them. Without this, the interviewee may feel uncomfortable and this will affect the resultant data. Clarification is therefore not only a practical, but also an ethical consideration.

3. The interviewer must maintain interest during the interview. The interviewee must be motivated and made to feel that his or her participation and answers are valued, for his or her cooperation is fundamental to the conduct of the research.

Another approach which the researcher found helpful was to adopt a technique called 'sanctioning' as suggested by Lummis (1987), where the question was prefaced in such a way as to enable the individuals to feel that their experiences are shared by others, and thereby encourage them to talk more openly.

Lummis (1987) gives this advice:

"The art of good interviewing lies in being able to keep most of the interview conversational while following various digressions, remembering which questions that flow of information has answered and yet being prepared to question more deeply and precisely when necessary".

The researcher also found it interesting to employ 'vignettes', that is, questions which ask people for their responses to situations involving hypothetical third parties, as a means of eliciting information about values and beliefs (Finch, 1987).

Before ending the interview, the respondents were given the opportunity to make any comments on the subject or other issues that had not been covered in the interview. Some respondents commended the researcher for undertaking the study, while there was a number who also wanted to know what other bankers' views were on the issues. The researcher concluded the interview by politely thanking the respondents for agreeing to participate in the study. The researcher also noticed that some respondents had indeed enjoyed the discussions, and that it had given them the opportunity to take a broader perspective.

Immediately after each interview, the researcher went over the interview transcripts and notes to make certain that they made sense, to uncover areas of ambiguity or uncertainty, and to review the quality of data received from the respondent. If any areas of vagueness were found, the researcher contacted the respondent again by telephone for clarification. This process enhances one's faith in the validity of the answers (Measor, 1985; McKee & O'Brien, 1986; Patton, 1990).

5.10 ANALYSIS OF DATA

The analysis aspect in research is a process of making sense, of finding and making a structure, and giving meaning and significance for the researcher and the target audience (Jones, 1985). In quantitative research, the purpose of data analysis is to satisfy three main objectives: (a) getting a feel for the data, (b) testing the goodness of data, and (c) testing the hypotheses developed for the research (Sekaran, 1992). The feel for data will give some ideas of how good the scale is, and how well coding and entering the data have been done. The testing of goodness of data can be accomplished through factor analysis, Cronbach Alpha or the split-half reliability of the measure. Hypothesis testing can be achieved by appropriate statistical tests, the results of which will determine whether or not the hypotheses are substantiated.

However, in qualitative research, the process of analysing data is eclectic, and there is no 'right way' (Tesch, 1990). The analysis requires that the researcher be comfortable with developing categories and making comparisons and contrasts. It also requires the researcher to be open to possibilities and see the contrary.

Patton (1990) argues that qualitative analysis involves making sense out of what people have said, looking for patterns, putting together what is said in one place with what is said in another place, and integrating what different people have said. The process of interpretation is highly creative, but also messy, time-consuming and often generates much stress.

As noted by Patton (1990):

"Analysis of qualitative data is a painstaking process requiring long hours of careful work going over notes, organising the data, looking for patterns, checking emergent patterns against the data, cross-validating data resources and findings, and making linkages among the various parts of the data and the emergent dimensions of the analysis".

Having understood the different perspectives of the two techniques, the researcher decided to employ the analysis that suits the nature of this research design. Since both structured and open-ended questions were used in the interviews, this analysis took both of the two forms, ie. a statistical analysis involving mathematical properties, and a more interpretative analysis to bring meaning and insight to the words and acts of the respondents in the study.

Data from the structured questions were processed using the Statistical Package for Social Sciences (SPSS) (Nie et al, 1975):

"SPSS is an integrated system of computer programmes designed for the analysis of social science data. The system provides a unified and comprehensive package that enables the user to perform many different types of data analysis in a simple and convenient manner. SPSS allows a great deal of flexibility in the format of data. It provides the user with a comprehensive set of procedures for data transformation

and file manipulation, and it offers the researcher a large number of statistical routines commonly used in the social sciences".

These data were analysed in several ways. First, a frequency distribution generating absolute and cumulative frequencies, and percentages was calculated for each question. Frequency is a statistic that tells as how many times a given score occurs in a collection of data (Bradley & McClelland, 1963). Frequency was therefore used to describe the demographic characteristics of the respondents. Second, a measure of central tendency (mean) was calculated for the purpose of comparison of data with other questions. The third group of statistics used were measures of dispersion (standard deviation) calculated to determine the statistical spread of respondents' answers.

The reliability or accuracy of the measuring instrument contained in the questionnaire is also important in this study. One of the most widely used techniques is the Cronbach's Alpha reliability coefficient. A high reliability coefficient (.70 or higher) means that the test accurately measured some characteristics, and that the individual items on the test produced similar patterns of responses in different people. Therefore, a high value means that the test items are homogenous and valid (Bruning & Kintz, 1977; Churchill, 1979; Hull & Nie, 1981). For this study, the Cronbach's Alpha reliability coefficient was calculated and measured at 0.804, and the result shows that all instruments displayed high reliability factors.

The use of statistical tools in the analysis does not imply that the researcher intended to infer the studies to a larger population. Rather it serves as a complementary tool to the qualitative approach taken in this study. Responses from the interviews were also given in a narrative format to illustrate ideas or perceptions expressed.

As mentioned earlier, there is no single set of rules in analysing data from qualitative research. It is possible, however, to identify common features in the methods of analysis used across different studies, and which can provide guidelines for the approach taken by the researcher in this study. Miller & Crabtree (1992) identify four main approaches in which qualitative data can be analysed. These are:

1. Quasi-statistical

This analysis seeks to turn the textual data into quantitative data that can be manipulated statistically. The approach is best illustrated in the technique of content analysis (Berg, 1989; Patton, 1990; Easterby-Smith et al, 1991; Miles & Huberman, 1994). This technique is designed to make inferences by systematically and objectively identifying special characteristics of messages (Holsti, 1969; Weber, 1985). The condensed data will then become meaningful, which allows comparison with the literature. The process of analysis starts once the contents of interviews are transcribed. These data are organised into topics and files, and then classified. The purpose of classifying data is to facilitate the search for patterns and themes within a particular setting (Patton, 1990). Berelson (1952) describes it as a research technique for the objective, systematic and quantitative description of the manifest content of a communication, while Emory & Cooper (1991) use it to measure the semantic content or the 'what' aspect of a message.

2. Template

The analysis of text is through the use of an analysis guide or template consisting of a number of categories or themes relevant to the research question. The template derives from theory, research tradition, preexisting knowledge and/or a summary reading of the text. This technique is more open-ended, and the template is revised many times until a pattern of themes emerges, which is then interpreted qualitatively, rather than statistically. The creation of codes in the template can vary from one advocated by Miles and Huberman (1984) which relies on existing research or theoretical considerations, to those that are formulated only after the researcher has read over a large amount of the interview transcripts.

3. Editing

This approach is termed editing because the interpreter enters the text much like an editor searching for meaningful segments, cutting, pasting, and rearranging, until the reduced summary reveals the interpretive truth in the text. The most well-known example of this approach is the grounded theory, which was formulated by Glaser & Strauss (1967). The key feature is that interpretations emerging from analysis of a particular theme or category are repeatedly compared with the original textual data. Through constant comparison, categories may emerge and theories be developed. Lonkila (1995) contends that this approach is frequently employed in qualitative research, and the analysis provides a well-written and detailed explication of the research being carried out. Lonkila (1995) also describes the process of analysis as follows:

"The researcher starts by reading and carefully analysing a small amount of data. He analyses the data by following very detailed and complex procedures and "rules of thumb". During the analysis, the researcher is continually asking questions about the data and checking them by constantly comparing different instances of data. When necessary, the researcher collects new data based on "theoretical sampling", a sampling procedure directed by the categories of the emerging theory. During the whole research process, the researcher writes "memos" on his ideas about codes, their inter-relations, new directions for the research, etc, and draws diagrams visualising his thinking about the data. Continuous interaction between the collecting and coding of data, and the writing of memos is essential. As the research advances, the researcher develops an increasingly abstract and complex conceptual structure, specifying the connections between the concepts of the emerging theory and regularly returning to the data to check whether this theoretical structure is in fact supported by the data".

4. Immersion/crystallization

Under this approach, the researchers immerse themselves in the research subject over a prolonged period of time, and produce an account of their findings through analytical reflection and intuitive crystallisation of meaning. This cycle of immersion and crystallisation is repeated until the reported interpretation is reached.

The researcher did not adopt any specific models in analysing the qualitative data, but seems to follow the two types mentioned by Miller & Crabtree (1992), that is, the quasi-statistical and template. This suits the relatively focused nature of this study, where the decision-making process of bank managers was examined. The quasi-statistical approach seeks to turn the data into quantitative forms by systematically and objectively identifying specific themes and patterns. On the other hand, the template approach entails the use of guidelines or codes in the analysis. This analysis starts with a basic set of codes based on a priori theoretical understandings, and expanding on these through readings of interview transcripts.

The researcher began the analysis by reading all interview transcripts and notes carefully to identify the emergent patterns and relationships. This phase of analysis was the most difficult, complex, ambiguous, creative and fun (Marshall & Rossman, 1989). The patterns and categories were identified, sometimes with the help of existing literature and theories, and also the experience of the researcher in a similar field. Patton (1990) also contends that a significant part of the analysis relies entirely on the researcher's own intelligence, experience and judgement. These patterns and categories were then evaluated and examined for relationships with the research questions. This was to determine whether or not the data were useful in illuminating the questions being explored, and whether or not they were central to the research issue. Those that the researcher felt relevant to the research questions were coded. During this process, it was also found necessary to modify the codes in the template by adding new features and eliminating any deficiencies. While coding, narrative statements by bank managers around specific points were noted. These statements would be used subsequently to illustrate the arguments and findings. The researcher worked back and forth between the transcripts to verify the meaningfulness and accuracy of the categories. This process was repeated several times until the categories or patterns became salient.

5.11 LIMITATIONS OF STUDY

The main limitation of the study was the small, non-representative size of the sample that prohibits generalising the findings to all the banks in the country. Furthermore, due to a geographical constraint, the respondents selected were confined to only five northern regions. Thus the sample may not truly represent a cross-section of bankers. This choice of sampling and sample size is a function of the research design used, and the cost and time constraints. Nevertheless, it is felt that the opinions and views expressed by the respondents are of a significant value to the objective of the research in particular, and to the banking industry in general.

There also exists a dearth of prior developed research and theory on a similar issue upon which to formulate hypotheses or foundations for this study. Most of the literature available was in professional journals or textbook that the researcher sometimes found difficult to adapt to the academic nature of this research. Furthermore, as there was no such studies being conducted in Malaysia before, this study was exploratory in nature, and hence the methodology used should not be inferred as the 'best' approach in understanding the issues.

Another limitation was the manner in which the questionnaire was formulated, and used in the interview. The main objective of this research was to understand the process of making a decision in a realistic or a close to an actual situation as possible. However, the researcher is not a 'real' entrepreneur, and the respondents also knew they were not dealing with a genuine business proposition. Thus, the interview may be superficial, and the finding does not give a 'true picture' of the lending decisions among the bankers.

During the fieldwork, the researcher had to contact and obtain permission from the banks' head offices prior to interviews. This may create an element of bias, when the respondents were forced to entertain the researcher because of directives from their superiors. In the actual situation, prospective borrowers may seek funding directly at the bank's branch offices, in which their loan application is sometimes being recommended for approval at the head office levels. Because of 'interference' from the head offices at the earlier stage, an environment of artificiality maybe created in the interview.

The interviews were also conducted during a period of adverse economy. It was therefore a time of great uncertainty for many of the respondents, and this may have undoubtedly been reflected in the respondents' decisions when assessing the business propositions.

Another limitation was that the study failed to identify the distinct ethnic groups among the small business community in Malaysia. The business proposition used in the interviews was reflective of only one ethnic group. The Malaysian small businesses, like the small firms per se, are not a homogeneous group with uniform needs and problems. The Bumiputera community face more problems in the financing of the businesses compared to their Chinese counterparts, and they also lack access to the financial institutions.

These limitations, however, did not nullify the implications of this study vis-à-vis previous studies or theories on bank decisions on lending to small businesses. The findings may indicate that previous studies have used a model or tool that failed to reflect adequately the complexity of a bank decision-making process in a different environment. Thus, this study may be viewed as the strength of an interpretive research that truly breaks new ground.

CHAPTER SIX

6. ANALYSIS AND FINDINGS

This chapter presents the analysis and findings of the study. Major attention is given to two components of the framework, namely the decisions on the business proposition, and the interpretation of perceptions based on a set of criteria.

The finding on the business proposition is examined first. It is divided into two major sections. The first section presents the demographic characteristics of the respondents, and the second section shows a scoring and a discussion of respondents' decisions on the business proposition. The findings are based mainly on the interpretations, discussions and observations made by the researcher during the interviews. Narrative quotations are sometimes used to illustrate the arguments and findings. Because of the method used in the interview, some of the respondents' original words might have been lost during the recordings. It should also be mentioned here that some of the findings in the chapter were obtained not from the questions in the questionnaire, but rather from impromptu discussions with the bank managers throughout the interviews.

6.1 DEMOGRAPHIC CHARACTERISTICS

6.1.1 Sex

Table 6.1 below shows that the respondents were predominantly male, although the percentage of females was quite significant. This probably reflects that the banking industry is still male-dominated at the higher managerial positions. A previous study by Mahmood (1996) confirms this male dominance, with 97.3 per cent of the branch managers surveyed found in that group.

Table 6.1: Classification of Respondents by Sex

Sex	Frequency	Percentage
Male	34	85.0
Female	6	15.0
	40	100.0

6.1.2 Age

It can be seen in Table 6.2 that about 55 per cent of the respondents were in the age group of 40 years old and below. This indicates that the bank managers under study at the branch level were on average of young age (if those above 40 are considered to be older managers). Only one respondent, or 2.5 per cent, was above the age of 50 years. Although this finding cannot be generalised that the Malaysian bank branch managers are relatively young, it nevertheless concurs with that of a previous study by Ismail & Keang (1991). The study surveyed 220 managers from the branches of local banks throughout Malaysia, and found out that 63 per cent were below 40 years old, and only 3.7 per cent were above 50 years old. Mahmood (1996) also found that only 1.8 per cent of the bank branch managers surveyed were at the age of 50 and above.

Table 6. 2: Classification of Respondents by Age

Age in Years	Frequency	Percentage
30-35	5	12.5
36-40	17	42.5
41-45	13	32.5
46-50	4	10.0
Above 50	1	2.5
	40	100.0

6.1.3 Academic qualification

Nearly three-quarters of the respondents were graduates, either with a degree or diploma qualifications (Table 6.3). This also reflects the relative importance of paper qualification for managerial positions in the banking industry.

Table 6.3: Classification of Respondents by Academic Qualification

Qualification	Frequency	Percentage
Non-graduate	11	27.5
Graduate	29	72.5
	40	100.0

6.1.4 Length of time in banking

Table 6.4 shows that 25 per cent of the respondents had served in the banking industry for more than 20 years, while another 37.5 per cent had been in the industry for the last 15 years. Only 10.0 per cent of the respondents had less than 10 years' experience in the banking industry. It appears that a lengthy banking experience was an important criterion for appointment to managerial positions.

Table 6.4: Classification of Respondents by length of time in Banking Industry

Number of years	Frequency	Percentage
Less than 10	4	10.0
10 but less than 15	11	27.5
15 but less than 20	15	37.5
20 and above	10	25.0
	40	100.0

6.1.5 Length of time as bank manager

Table 6.5 indicates that 50.0 per cent of the respondents had less than 5 years' experience in a managerial capacity in the bank. 27.5 per cent of the respondents had served more than 5 years but less than 10 years as bank managers, while 7.5 per cent had 15 years or more but less than 20 years. None of the respondents interviewed had 20 years or more experience in managerial positions in the banks. This could imply that bank managers would not stay for a long period of time at the branch level.

Probably, long-experienced branch managers would be pulled back to the head office for more responsible positions.

Table 6.5: Classification of Respondents by length of time as Bank Manager

Number of years	Frequency	Percentage
Less than 5	20	50.0
5 but less than 10	11	27.5
10 but less than 15	6	15.0
15 but less than 20	3	7.5
	40	100.0

6.1.6 Number of employees

Table 6.6 shows that 25.0 per cent of the bank branches had fewer than 15 employees. More than half had 15 or more employees but fewer than 40, while one bank in the study had a total of 60 and more employees. This again reflects that the number of employees at the branch levels of the banking industry in Malaysia was relatively small.

Table 6.6: Classification of Respondents' Banks by Number of Employees

Number of Employees	Frequency	Percentage
Less than 15	10	25.5
15 but less than 25	13	32.5
25 but less than 40	10	25.5
40 but less than 60	6	15.0
60 and above	1	2.5
	40	100.0

6.1.7 Status of bank

Table 6.7 below shows that nearly half of the banks in the study were from Tier I category, and another half were Tier II. As mentioned earlier, Tier I banks have been accorded the status by the central bank because of their size, and as such can be classified as big banks. Meanwhile, the Tier II banks were considered as smaller banks. The fairly balanced number of bank status in the study is given for comparative purposes.

Table 6.7: Classification of Respondents' Banks by Status

Status	Frequency	Percentage
Tier I	19	47.5
Tier II	21	52.5
	40	100.0

6.2 SCORING OF BANK MANAGERS' DECISIONS ON SMALL BUSINESS PROPOSITION

6.2.1 Bank Managers' Lending Decisions

Table 6.8 below is the scoring given by the bank managers when assessing the small business proposition put forward during the interviews. They were presented with a business proposition asking for a loan of RM200,000. The company was newly incorporated, with a paid-up capital of RM100,002, contributed equally by its two shareholders. The shareholders, who constitute the management team, were highly qualified, and had a total of 40 years' experience in the related field.

The main business of the company was in consultancy services, and the loan requested was to finance the conversion work for its first project. The project involved the conversion of four-storey buildings into classrooms, computer lab and administrative office for a client, an established local college. The initial costs were the renovations and maintenance of the buildings, which were then subleased to a client. Due to the nature of the project, the company's income would be guaranteed during the agreement period, unless the client defaulted in payment. Therefore, the element of risk is always there, given that the company may not receive the required income to pay the debt. It has been a normal practice by the banks here to ask the income to be reassigned directly to them in respect of the repayment of loans.

As explained earlier, the business plan was modified from an original plan used by a real entrepreneur to obtain the loan. It was based on a sector related to the construction industry, which was at peak in the late-1980s and 1990s. In fact, the construction industry was the catalyst of the economic growth Malaysia was enjoying then. Furthermore, the biggest portion of bank loans was channelled to this sector during the last three years. Hence, the business plan can be said to reflect a typically new venture of small businesses in Malaysia during the course of the fieldwork.

The researcher, acting as one of the shareholders, presented the business proposition to argue for the loan. The researcher, as in most small business loan applications, had an informational advantage on the proposed venture over the bankers. The researcher had a faith that the project was viable and capable of achieving good returns. Nevertheless, the final decision had to come from the bankers themselves, no matter how convincing the researcher was on the proposed project.

The managers' decisions on the proposition were scored on a 10-point scale, with greater than 5 being a positive decision (willing to approve the loan), and less than 5 being a negative decision (unwilling to approve the loan). Although in studies by Deakins & Hussain (1994) and Fletcher (1995) a score of 5 was given as being a positive decision, a score of 5 in this study means the decision is deferred or put on hold. The researcher decided to include a "deferred decision" after a series of discussions with the bank managers during the pilot work. It was suggested that in normal practice, bank managers may defer the decisions because they need to investigate further, probably due to a lack of crucial information, or the managers could not decide yet due to certain factors such as the changing bank policies or the adverse economic situation. It is also necessary to note that the scorings were given by the managers themselves rather by the researcher, as was done in earlier studies by Deakins & Hussain (1994) and Fletcher (1995). The reason being the researcher was not an expert in the field, and therefore avoided the possibility of bias in the findings. Furthermore, by asking the bank managers themselves to provide the scoring, it gave them the opportunity to look the business proposition as a whole rather than on certain criteria such as collateral or projected figures.

Table 6.8: Scoring of Bank Managers' Decisions*

Score	Number of Respondents	Percentage
0	0	0
1	0	0
2	4	10.0
3	8	20.0
4	3	7.5
5	6	15.0
6	8	20.0
7	8	20.0
8	3	7.5
9	0	0
10	0	0
	40	100.0

* Mean 5.05
Standard Deviation 1.88

Table 6.8 shows a considerable variation in the lending decisions by the bank managers. Nineteen, or 47.5 per cent, of the bank managers gave positive responses to the proposition and agreed to lend the amount as required. Only 37.5 per cent were unwilling to provide the loan according to the business proposition. However six, or 15.0 per cent, of these managers could not make the final decision, although they were receptive to the proposition. They claimed that it lacked some information which, according to them, was vital for the decision on the viability of the proposed project. Four of them asked for more details about the client, Kedah Utara College (KUC). The reason below was given by one of these managers:

"We found that the project is viable, and we are willing to consider the application positively, but we are still unsure on the viability of your client, that is, the KUC. If you can provide further information on your client, say, its financial statements for the last three years, and the profile of its directors, then we can make our decisions".

In studies by Deakins & Hussein (1994) and Fletcher (1995), a wide degree of variations of opinions among bankers in the UK were recorded when making lending decisions on small businesses. They found that these variations exist despite attempts by banks to provide general guidelines such as mnemonics, manuals, checklists, etc. Similarly, the findings in this study suggest that bankers in Malaysia were not consistent in their lending decisions for small businesses, although they were provided with a standard form to review the applications. This form, usually known as the Application for Accommodation (A/A), contains perhaps the most important information concerning the applicant. The form incorporates the common pattern, such as particulars of applicant, purpose of loan, types and amount of loan requested, existing and previous borrowings from other banks or financial institutions, security and collateral offered, and the financial information. 80 per cent of the managers interviewed mentioned that they used the checklist provided in the A/A form to assess the proposition. The finding also revealed that all the 19 bank managers who gave positive scoring on the proposition used the checklist in their assessments.

Notwithstanding, there was some consistency in the scoring among the managers who accepted the proposition. 16 of them gave a score of 6 or 7, while none came out with a score of 9 or 10. Only 3 managers gave a relatively high score of 8. This could probably reflect a conservative approach taken by the bankers, where any decisions on new ventures were made cautiously. One of them was impressed with the project, and gave the following view:

"I have a strong feeling that your project is viable, and I am definitely going to recommend to the Committee to consider a loan of RM200,000."

6.2.2 Reasons for Accepting or Rejecting the Proposition

There were some consistencies in the reasons behind the decision by the bankers when they accepted the proposition. A majority of the bank managers based their decisions mainly on the expected cash flow from the client (See Table 6.9). These managers insisted that repayments should be made through assignment of rentals direct to the bank. They also seemed to have looked positively at the guaranteed source of income as a sufficient form of security to justify for the loan. Only two of the bank managers who accepted the proposition failed to mention the availability of guaranteed payment as a main reason for their decisions. However, they gave a score of 6 each because of a guarantee accorded by the CGC. On the other hand, the 8 managers who accepted the proposition under the CGC loan only gave a score of 6 or 7, and none a score of 8. Furthermore, they mentioned that the CGC guarantee acted only as an added security in enhancing the creditworthiness on the viability of the business. When probed further, most of the managers generally support the CGC scheme but they took a cautious approach because of the uncertainty on the security of the loan in the event of default. There were also 9 bank managers who were impressed with the credentials of the directors whom they believe could be an important factor in ensuring the success of project and/or in safeguarding the loan to be made to the firm.

Not surprisingly, because of a new venture, only 7 of the bank managers mentioned viability of project as a reason for accepting the proposition. But they all gave a relatively high score of 7 or 8 for the project.

Table 6.9: Reasons for Acceptance of Proposition

Reason	Number of Managers
Guaranteed source of repayment	17
Experienced directors	9
Classified under CGC loan	8
Viability of project	7

On the negative responses, only 4 bank managers, or 10.0 per cent, gave a relatively low score of 2. Most of the managers were unwilling to consider the proposition because of its lack of collateral, new venture, lack of track record and unknown directors (See Table 6.10 below):

Table 6.10: Reasons for Rejection of Proposition

Reason	Number of Managers
No collateral	15
New venture	12
No track record	11
Inexperienced/unknown directors	10
Against bank policies	5

All the bank managers who rejected the proposition mentioned the lack of collateral as the main reason behind their decisions. These managers did not see the guaranteed source of rental income as a sufficient security to justify for the loan. They also mentioned that they would prefer collateral in the form of fixed or other tangible assets in order to reduce the risk of default.

A comment given by one of the bank managers:

"The first thing I'll ask you is the collateral and your experience in business. Your business plan looks good but it is only on paper, and in reality would not be the same. There are not enough assets to back the loan. The paid up capital is also insufficient. I am very concerned whether you can repay the loan. The business should have some kind of guarantee or proof that it can be viable at least in the first 3 years".

A significant number of bank managers also could not consider the proposition because of its new venture status and without sufficient track record, through which, according to them, it would be difficult to assess its creditworthiness. Another 10 of the managers did not consider the experience of the directors sufficient enough to justify the loan. Furthermore, they mentioned that the directors were of unknown standing and had no previous dealing with the bank.

A comment from one of the managers:

"In our bank policy, if a new venture comes without any collateral, the probability of rejection is 90 per cent. Although collateral is good for a loan application, I would still look at the capability of the applicant in paying back the loan. In your case,

beside your strength, I will also look into the strength of your client, the viability of its business and the capability and capacity to pay the rental. But in this situation, I would assume that your client has a high- risk venture and the capability to repay the loan is nil. So I would then look at your directors and your business. Since your directors are unknown to us and are of unknown standing, I would also consider your venture as a high risk and of no capability to repay the loan. Therefore I would reject the application".

There were also five managers who rejected the proposition because it was against their bank policies. One of them stated:

"I am sorry, I can't even consider your proposal at all because our bank's policy is not to entertain any new venture, no matter how viable it may look".

The reason given by these managers seem to have contradicted that of others from similar banks in the study who either accepted or rejected the proposition. None of the latter gave 'against the bank policy' as a reason behind their decision. Furthermore, it was mentioned earlier that the banks selected in the study had to fulfil certain criteria, one of which was having a specialised unit to handle the small business customer. Therefore, the question of not to accept the new venture because of a bank policy should not have arisen. There may be other reasons behind this decision. Maybe the bank managers simply gave an excuse to avoid further discussion with the researcher, or it shows a real attitude of some of the bank managers when dealing with a new venture, or maybe there were some communication problems with their head offices.

Deakins & Hussain (1994) also mentioned that bankers were more concerned with Type II errors, when deciding on a loan to small businesses, and could not bother with the Type I errors, because the outcome of the latter would not harm them. Similarly, a significant number of bank managers interviewed (77.5 per cent) agreed that the Type I errors would not have affected their performances, compared to Type II errors. Of these, 15 came from the managers who rejected the proposition, 4 who deferred the decision, and only 11 were from the managers who accepted the proposition. One of the managers gave this comment:

"I once recommended a rejection of a loan proposition from a prospective customer, and later I was made to understand that the person obtained a loan from another bank. Since then his business has been good. However, I never regretted my decision although I lost a potentially good borrower. My head office also knew about the situation but nothing happened".

Moreover, 25 bank managers also voiced their dissatisfaction with the approval authority at the head office level, which easily puts the blame entirely on the branch managers if the loan turns bad. A significant number of them (12) came from those who rejected the proposition. This seems to concur with earlier studies which found that bank managers in Malaysia were not satisfied with the lending decision authority, which mostly resided at the head office level (Ismail & Keang, 1991; Mahmood, 1996). A comment given by a bank manager:

"There is one big problem with the process of accountability in the decision making. Any recommendation from the branch is always stated 'approved as per recommended', meaning that in case the loan turns bad, the ultimate responsibility

goes to the branch manager, and not collectively. Thus we are wary and very cautious when recommending the loan application for approval".

This finding should have an important policy implication considering that the branch offices are the frontline personnel whom the customers may have had to approach when dealing with the banks.

It was also mentioned in the literature that small banks tend to lend a larger proportion of their assets to small businesses than do large banks, and small banks are also primary lenders to the small business sector (Berger & Udell, 1995; Peek & Rosengren, 1995; Levonian & Seller, 1996). Similarly, the findings in this study reveal that managers of smaller banks (Tier II) had a relatively higher rate of approval on the proposition than those managers of larger or Tier I banks (See Table 6.11 below).

Table 6.11: Comparison of Yes/No Decision*

	Tier I	%	Tier II	%
Yes	8	42.1	11	52.38
No	8	42.1	7	33.33
	16		18	

* A score of 5 is not included

A comment from a Tier II bank manager who gave a score of 7:

"The first thing that I will do is to analyse you. I want to understand what you really want to do. If I have this understanding, then I will look at your capability and

experience in undertaking your venture. If I am comfortable with you and your business, then I will look further into how you can repay the loan. Since you don't have any track record, then I also want to know how comfortable you are with your project. Collateral to me is secondary, and if you can convince me that returns from your business are secured, and that you can repay the loan, then I'll consider the loan. I don't believe in outright rejection, and I will consider various aspects before I decide to recommend or not to recommend the loan".

It is also worth mentioning that some contextual features of the bankers may influence the decision on the proposition. The bankers' educational background and previous experience play a major role in structuring perceptions, values and beliefs, and hence their definitions of project viability and risk (Sargent & Young, 1991). Two interesting features are revealed in this finding. First, the bank managers who are graduates tend to use more quantitative information than their non-graduate counterparts (See Table 6.12 below).

Table 6.12: Comparison between graduate and non-graduate managers

Score	Non-graduate	Graduate	Total
Yes	7	12	19
Deferred		6	6
No	4	11	15
	11	29	

Most of them who rejected the proposition cited the lack of track record as the main reason behind their decisions. Furthermore, the 6 bankers who deferred their decision also came from the graduate category of the managers. The reasons given, such as the lack of financial statements on the part of the client, augur well for the modus operandi of the bankers with a quantitative bias. On the other hand, the non-graduates focused mainly on the qualitative aspect of the proposition such as the quality of project and management.

A response from a graduate bank manager who accepted the proposition with a score of 7:

"When it comes to projected figures, I would always look at the assumptions used, whether they are logical or not. Your paper is quite comprehensive and easier to process, and the venture is still within the scope of productive sector as defined by the central bank. I would consider your application under clean basis (without collateral)".

A response from a non-graduate bank manager who gave a score of 7:

"Normally for a new application, I would assess the person first. I want to know what he or she wants to do, and whether he or she understands the business. If the bank is keen with his or her business idea, then I will ask him to prepare a business plan. At this stage, our inclination towards the loan application is positive. Your venture looks viable, and the directors are all qualified and well experienced in their field".

Second, those managers in the category of 10 years but less than 20 years of banking experience were more willing to give positive consideration to the proposition than those with 20 or more years' experience (See Table 6.13 below):

Table 6.13: Comparison of decision based on banking experience

Score	<10 years	10<20 years	>20 years
Yes	1	15	3
Deferred	1	5	
No	2	6	7
	4	26	10

This finding should also have an important policy implication on the banking industry when posting senior and experienced personnel to manage the branch offices. It is sometimes helpful to have bank managers who are still in their prime years with the banks, and who would be more aggressive to increase their loan portfolio for promotion prospects than those who have achieved their 'pinnacle', and thus would be more conservative to build up further loan portfolio.

Response from a bank manager with more than 20 years of experience:

"The paper looks nice and good, but can you really achieve it? I'm a straight-forward type, and if you can prove that the income is secured, then there is no problem. However, your company is a new one, and normally the chances to be considered for loans are small. Furthermore, for a loan of a 5 year period, the risk is too high. I would not recommend it".
(Score: 4)

Response from a bank manager with more than 10 but less than 20 years of experience:

"I found your project as viable and I would like to recommend a loan for a 5 year period. However, the loan of this amount needs to be submitted to the Head Office for approval. Normally about 80 per cent of what is recommended by my branch is approved by the Head Office".

(Score: 6)

It is also interesting to note that a significant number of bank managers who gave negative responses to the proposition had been in the branch offices for a relatively long period, including as officers, and were frequently moved from one place to another without being given much authority. It was pointed out earlier that most of the bank managers would not stay long at the branch level, and would probably be pulled back to head office for more responsible positions. However, it emerged that some of these managers were not given due recognition in terms of promotion, and were sometimes posted to various branches because of 'unsuitability' at the head office. It is generally accepted that employment in the banking sector is a tenured career, and therefore the norm of the industry is to place 'unsuitable' officers in less responsible positions rather than retrench them. These managers may have seen their prime time or were already content with what they had achieved in their career, and thus would resist any attempt to change their attitudes.

Notwithstanding the decision on the proposition, a majority of the bank managers interviewed showed a lackadaisical attitude when confronted with small business customers. There seemed to be no genuine interest among them to treat the small businesses as potentially profitable customers. Their approaches were more towards satisfying certain relevant authorities. It is established that some considerations were given to the small business propositions because of pressure from the authorities to fulfil the social responsibility towards the small business sector. A comment made by one of the managers:

"Sometimes, I would prefer to let go the loan granted to a small business customer and treat it as bad debt, rather than monitoring the account. It is cheaper this way".

Furthermore, a great number of these managers did not show any keenness to develop and establish a longer-term relationship with small business customers compared to larger ones. Although some of them showed enthusiasm when discussing the proposition, in reality these managers paid little or no attention to small business customers. They seldom seek new ventures for loans, and even for established small firms. Most of the marketing activities were focused mainly on those established companies or businesses that are perceived to be more stable and provide better returns to the banks. When asked about the availability of special loan schemes provided by the authorities to assist the small businesses, a majority of the managers had reservations on them, and some expressed that they had experienced problems before. One of them gave this comment:

"They can come out with various schemes, but in the end who is going to be responsible for the bad debts? Sometimes, I don't like the idea because it encourages lending to potentially bad customers".

This attitude is rather perplexing given that the banks under study have special sections that handle small business customers, and the branches are located in areas where the small businesses are dominant. Perhaps, at the time when the interviews were conducted, these managers were preoccupied with the economic crisis, and they were more concerned with the loan recovery rather than finding new customers. However, a more plausible explanation is that of the existence of 'irrational bias' that may have become built-in among these bank managers against small businesses (NERA, 1990). They may have some kind of misconceptions and prejudices that are often based on their previous experiences and background knowledge. This may be attributed to a general lack of understanding on the nature and characteristics of a small business among the bankers. Most of them tend to perceive small businesses as not being any different in terms of their needs and problems and therefore are not treated as such. However, evidence suggests that the small businesses are not homogeneous, and their financial needs are different, and so are their difficulties (Binks et al, 1992; Rosewell, 1996).

It is also possible that a lack of clear understanding on small businesses among the bank managers could cause some imperfections in their decisions on the proposition. Because these managers did not take real interest in the small business sector, they become less knowledgeable about its environment, and the needs and problems of the individual business. Hence, they tend to focus the small businesses as a single entity rather than categorising them into various sectors or industries as generally done with larger firms. This 'generalist' approach was also evidenced among bankers in the UK (Deakins & Hussein, 1994; Fletcher, 1995). As a result, these bankers contributed to the problems of adverse selection and moral hazard, since they did not have specialised industrial and sector knowledge to make good lending decisions. Furthermore, since these bankers had more experience in dealing with large firms, it is inevitable that they may draw upon those experiences by taking a similar approach when it comes to decisions on lending to small businesses. Lambden & Targett (1993) also found a similar problem among the bankers in the UK where they tend to take standard techniques used for larger businesses and apply them to small ones. Consequently, this can result in a biased decision.

6.2.3 Approach to Decision on the Proposition

In the earlier chapters the researcher mentioned the need to widen the scope of the study to include the socio-economic context in understanding the lending decision on small businesses. This was taken in view of a lack of research on similar issues in Malaysia, and therefore the researcher made an effort to focus too the analysis on the approach taken by the bank managers when making a decision on the proposition.

The literature in Chapter Three classifies the approach to decision-making under the two types of model, namely classical and administrative models (Daft, 1997). The classical model is considered more normative, because it systematically and rationally defines how decisions should be made, and provides guidelines for achieving the desired results. It also entails a wide use of quantitative decision tools such as decision trees, break-even analysis and operation research methods. On the other hand, the administrative model acknowledges the limitations in its search for alternatives, and the rational procedure is seldom used in approaching the problem. The decision-makers thus settle for a 'satisficing' rather than a 'maximising' solution. In the banking literature, the two approaches taken by bankers when dealing with small businesses were classified as qualitative and quantitative (Fertuck, 1982; Jones, 1982; Memon, 1984, Barona, 1985; NEDO, 1986; Berry et al, 1993a). A qualitative approach is associated with a mainly subjective judgement, while a quantitative approach emphasises a systematic gathering and objective analysis of information before making a decision.

Similar patterns emerged in the discussions of the approach taken by the bank managers when assessing the proposition. Both the qualitative and quantitative approaches were employed in their decisions. However, the quantum of usage is dependent on the characteristics of individual managers such as experience and educational background. It was revealed earlier that the bank managers who had more banking experience tend to put more weight on qualitative analysis, while those with higher academic qualifications focused more on analytical assessment.

The qualitative aspect of assessment seemed to focus mainly on the characteristics of the owner and the business. The bank managers mentioned that they sought the 'quality of management' as a vital element in assessing the proposition. Although there was no standard judgement on the issue, most managers agreed that it is based on the characteristics of the business and the owner. They also argued that since honesty and trustworthiness were among the elements that determined the character of a person, the focus on the person's willingness to repay the debt is crucial in the assessment. However, the managers stressed that honesty and trustworthiness alone are not enough without the skills and competence in managing the business. Because of the peculiarity in the management of a small business, it is the owner's ability that may contribute to the success of the business. These skills and competence are normally gauged through the record of the person, such as experience in the related field. For this reason, some bank managers were willing to accept the proposition based on the experience of the directors, while others were more inclined to look at the track record in managing the business, which was none. Therefore, the qualitative assessment of the person's character based on his or her personal and business past record seems to be the strongest feature in a lending decision for small businesses, rather than the nature of the business proposition envisaged for the future.

On the other hand, the quantitative assessment focused mainly on the financial information provided in the proposition, and other details given in the application form, or some materials obtained during the interview, where certain clarifications or justifications were made on the financial statements. It was also observed that many of the bank managers were highly suspicious of projected figures, especially on the forecasted profit and loss statement, and the cash flow. They complained that some figures quoted to them were unrealistic, and sometimes prepared without the basis or consideration of the actual business or conditions in the industry. They believed that these statements were prepared not for planning for the future operations of the business, but for the sole purpose of obtaining the loan. This may be the reason why a significant number of bank managers rejected the proposition because of a new venture where there is no track record to support its viability or to prove its ability to generate enough returns to enable it to repay the loan.

When analysing the financial information, the bank managers adopted the two approaches commonly identified in the literature as 'going concern' and 'gone concern' (Barona, 1985; Berry et al, 1993b). However, 77.5 per cent of the managers interviewed mentioned that they employ a mainly 'gone concern' approach in the financial analysis. This approach is normally popular with bankers who are more conservative in their lending. They are more interested in seeking the value of the assets that can be realised in the event of default in loan repayment. They are also concerned with how a loan would be repaid if the business fails rather than with the future prospects of the business itself. Some of the biases in the lending decisions on small businesses reported in a number of studies were also attributed to this approach (John et al, 1989; Lambden & Targett, 1993; Clay & Cowling, 1996). Similarly, all the 15 bank managers who rejected the proposition mentioned the employment of a mainly 'gone concern' approach in their decisions.

6.2.4 Intuitive Decision vs Analytic Decision

It was also noted earlier that lending decision-making is an area of human activity where there is much room for judgement under uncertainty. Under this condition, judgements are likely to be influenced by a variety of social and cognitive factors (Harrison, 1981; Simon, 1997). The literature mentions that individuals cannot make decisions on the basis of orderly rational analysis, and therefore they have to depend largely on intuitions. However, this judgement is not necessarily arbitrary or irrational because it is based on years of experience that enables individuals to identify solutions quickly without going through an analytical process.

The findings in this study acknowledged the influence of heuristic judgements in the lending decision on small businesses. 21 of the managers who gave either the positive or negative scorings on the proposition mentioned the use of intuitions in their decisions. Of this number, 12 were the bank managers who rejected the proposition. Interestingly, a significant number of bank managers who employed the heuristic judgements were those with 15 or more years of experience in the banking industry. When further asked about the frequency of usage in dealing with small business loan applications, more than four-fifths of the managers interviewed mentioned they used intuitions most of the times, while the others on certain occasions (See Table 6.14 below).

Table 6.14: Frequency of using Intuitions in Lending Decision

	Frequency	Percentage of bank managers
1.	Most of time	87.5
2.	Sometimes	12.5

This finding concurs with the literature that heuristics or intuitions are widely used in lending decisions on small businesses (Fertuck, 1982; Salisbury, 1984; Jankowicz & Hisrich, 1987). The widespread use of intuitions in lending decisions reflects the difficulties in making objective assessment when it comes to small businesses. This is largely true in the Malaysian context, where the small business sector is still far from the sophistication that is usually associated with larger firms (Chee, 1986; Faridah et al, 1990; Nawawi et al, 1990; Salleh, 1990; Haron & Shanmugan, 1994; Hameed, 1995). Furthermore, the emphasis on the characteristics of the business and the owner may have forced the bankers to focus more on the subjective nature of the person, rather than the quantifiable information. The situation is further aggravated by the asymmetry of information that is a common problem in the banking relationship with the small businesses. Therefore, the use of intuition sometimes helps in rectifying the gap of available information and other deficiencies on the part of the small business borrowers.

A comment given by one of the managers:

"I seldom forego my hunch or what people called intuition when making a lending decision. This is an inner sense that can guide you to identify whether a person is trustworthy or not. You cannot simply explain it, but after so many years dealing with the same things you tend to acquire these skills"

Another comment by another bank manager:

"I believe in my own ability to judge people. This is what banking is all about. There is no textbook that says people will back if you do this or that. You can predict but what can you know about the future. Therefore, you have to rely on your own intuition to make a judgement. It is difficult to explain, but you can sense it when you see the person, his business plan of after a chit-chat with him".

Argor (1989), Vaughan (1989) and Simon (1997), who support the use of heuristic or intuitive judgement, point out that it is not necessarily arbitrary or irrational because it may be based on years of experience that enable these managers to make positive decisions. The managers may also have confidence in the correctness of their decisions, and believe that intuitions help in these. This is especially true among the more experienced bank managers, where intuitive judgements were more frequently employed compared to younger and less experienced ones. Jankowicz & Hisrich (1987) mentioned that factors within the bankers and the environment influences them into making intuitive judgements.

However, an over-reliance on intuitive judgement can also lead to errors in the lending decisions (Kahneman, Slovic & Tversky, 1982; Barona, 1985). The focus on mainly qualitative characteristics of the owner and the business can contribute to systematic errors of availability and representativeness heuristics (Kahneman & Tversky, 1973; Tversky & Kahneman, 1973). Bank managers may commit availability heuristics error because they sometimes do not have much information on the small business applicants, except on what they perceived on past experience. Experienced bankers normally have more tendencies to make this kind of judgement. These managers are often preconditioned to organise their perceptions into making judgements through familiarity with the kind of situation with which they were confronted. An example is a comment from one of the more experienced bank managers on the proposition:

"I had bad experience with this project before and the loan payment was defaulted. Now I found it difficult to consider a similar project, although you may want to convince me of its viability".

An error in qualitative judgement can also be attributed to representativeness heuristics where the individuating information is dominant in intuitive prediction. This holds true among some of the bankers who had a preconceived mind-set on small business applicants even before the prospective customers came to the banks. An example is the comment from one of the bank managers:

"It is difficult to say but it is a fact that nine out of ten small business customers who come to this bank are potential defaulters. So that's why I am a bit reluctance to

consider any loan application from these people unless I am truly convinced that they are going to be good paymasters".

Notwithstanding, as mentioned earlier, the use of intuition may not necessarily lead to bad judgements. It could, on the contrary, lead to a good decision because it enables the bank manager to respond to a situation that is not available for rational decision-making. Furthermore, intuitive judgement is a form of managerial skill that requires many years of experience and training.

An alternative to heuristic or intuitive judgements, as mentioned in the literature, is the use of quantitative or analytic models. A number of the bank managers interviewed attempted to employ some analytical tools such as financial ratios and sensitivity analysis when assessing the proposition, but the researcher did not find any sophistication in the methods used. None of them also claimed to have used or employed a highly formalised quantitative model or credit-scoring system in their decisions on lending to small businesses. It is believed that this quantitative method of assessment is still unknown or is not yet popular among bankers in Malaysia. Although the credit-scoring techniques have gained popularity among bankers in some industrialised countries, there is little evidence to support their application here. As far as the banks in Malaysia are concerned, the use of quantitative models or credit-scoring techniques is still new to them.

It is believed that there is a tremendous benefit in using the credit-scoring technique. It can assist the bankers in quickly eliminating potential defaulters among the small business applicants without going through a more rigorous and time-consuming assessment. As mentioned in the literature, the technique is used to predict the probability that a potential borrower will default or become delinquent (Mester, 1997; O'Connor-Clarke, 1998). However, the effectiveness of this technique depends greatly on the development of a good model, and to build a good model needs sufficient information on the prospective borrower. But the asymmetry of information prevalent among the small businesses will make the development of this model very difficult. The similar situation in Malaysia may also discourage the development of the scoring technique among the bankers, where there are a significant number who still believe in their own judgements as second to none. These bank managers were sceptical about the importance of the technique in lending decision. Their views generally stemmed from a lack of appreciation of what it can do, and a disbelief that it can improve the quality of decision-making. This can be observed by a comment by one of the managers:

"The model or any quantitative analysis is good on paper, and probably can help in my assessment of a prospective customer. But I don't have faith in it because it cannot tell me about the person. You can see the statistics, maybe they look good, but still you need your own judgement to determine whether that person is good or not".

Nevertheless, the researcher feels that a formalised model, such as the credit scoring technique, is useful to complement the intuitive-based decisions often used by the bank managers. As pointed out by Cooke et al (1984), a model can be used to aid decisions in many ways and at all stages in the decision process. It can enhance the decision-maker's understanding of the decision, stimulate creativity in the search for possible solutions to the problem, and aid the evaluation of alternative courses of action. Thus, a model can add another dimension to improve the quality of the lending decision, and perhaps can result in an increase in lending to the small business sector.

6.3 CRITERIA USED IN LENDING DECISIONS ON SMALL BUSINESSES

The second section of this chapter analyses the interpretations of the importance of criteria used by the bank managers when assessing the small business proposition, both for new ventures and existing businesses. These bank managers were presented with a semi-structured form of questionnaire adapted from earlier studies, and also from information obtained through a series of discussions with bank managers during the pilot work. A test was conducted during the analysis using the Statistical Package for the Social Sciences (SPSS), and an overall Cronbach's Coefficient Alpha of 0.804 was measured, indicating a high degree of reliability. It was also mentioned in the preceding chapter that the use of statistical tools in the analysis was merely to complement the qualitative approach taken in this study. Responses from the interviews were given in a narrative format to illustrate perceptions or attitudes expressed.

A list of 20 criteria normally used in the assessment of a small business loan proposition was presented to the bank managers, and they were asked to rate the relative importance of each of the criteria on a 5-point scale ranging as follows:

Importance scale	**Point value**
Great importance	5
Importance	4
Moderate importance	3
Slight importance	2
Unimportance	1

The interpretation of data was based on the mean response and its standard deviation for each of the criteria listed in the questionnaire. The mean provides a basis for comparing the degree of importance that the respondents attribute to each criterion. The coefficient of variation was also computed as a measure of the diversity of responses to the mean response. The larger the coefficient of variation, the larger the difference of opinion is assumed to have been among the respondents as to the importance of the particular criterion in influencing the lending decision.

A summary of the mean, standard deviation and coefficient of variation of the responses is presented in Table 6.15 below:

Table 6.15: Ranking of Criteria used in Assessing Small Business Propositions

Criterion	Rank Order	Mean	SD	Coefficient of Variation
Intended purpose of loan	1	4.47	0.60	0.13
Size of loan relative to size of business	2	4.45	0.50	0.11
Loan activity at other banks	3	4.28	0.82	0.19
Repayment of previous loans	4	4.20	0.88	0.21
Type of business activity	5	4.18	0.71	0.17
Gearing	6	4.15	0.66	0.16
Trade debtors	7	4.05	0.64	0.16
Repayment schedule	8	4.03	0.89	0.22
Trading experience	9	4.00	0.64	0.16
Existing profitability	9	4.00	0.64	0.16
Equity stake in business	11	3.95	0.75	0.19
Trade creditors	12	3.90	0.67	0.17
Net profit to sales	13	3.88	0.69	0.18
Projected income	14	3.80	0.97	0.25
Liquidity ratios	15	3.78	0.83	0.22
CVs of clients	16	3.68	0.73	0.20
Availability of collateral	17	3.55	0.99	0.28
Charge on assets	17	3.55	0.81	0.23
Length of time doing business with Bank	19	3.45	0.71	0.20
Government guarantee of loan	20	3.23	0.95	0.29

The table shows that ten of the criteria ranked may be considered to have been of importance in the lending decisions (mean rating value of 4 or more) and another ten of moderate importance (mean rating value of between 3 and 4). None gave a mean value of below 3. The coefficient of variation shows an increasing trend as the mean decreases, and this indicates a higher diversity of opinion among the bank managers, especially at the lower end of the mean value.

These findings highlight the fact that bankers perceive all the criteria used in the lending decision as important, although some may be more important than others. They also remarked that all or most of these criteria mentioned were employed in their lending decisions, although the frequency of usage varies among them.

It is also clear that the bank managers, when dealing with small business propositions, were preoccupied with risk. The criteria ranked at the top are mostly associated with, or attempt to measure, the risk in granting loans. This preoccupation is not difficult to understand, since banking like other businesses is a profit-making concern. Furthermore, lending to small businesses is always perceived to involve high risk compared to larger firms. This is also indicative that market imperfections occur in lending to the small business sector mainly because of information asymmetries, whereby the small business owner generally has much better information than the bank on the firm's performance, and has more control of the outcome. This concurs with previous studies by Binks, Ennew & Reed (1992), Hutchinson & McKillop (1992), Berry et al (1993a), Deakins & Hussain (1994) and Fletcher (1995), which suggest that bankers tend to put more effort to minimise risks in their decisions on lending to small businesses.

Generally, the bank managers' perceived risk of lending decreases as the amount of knowledge about a business or customer applying for loan increases. This also concurs with the literature that banks can gain valuable information on a small business over the course of their relationship, and then use this information to help make lending decisions (Peterson & Rajan, 1994; Berger & Udell, 1995; Blackwell & Winters, 1997; Cole, 1998; Harhoff & Korting, 1998; Meyer, 1998; Udell, 1999). Consequently, the banks may expect the lending to be less risky.

The ten criteria with an overall mean of 4 and above are discussed below:

6.3.1 Intended purpose of loan

With a mean of 4.47, intended purpose of loan was ranked as the most important among the criteria used in the lending decisions on small business propositions. Of the 40 respondents, 21 rated it 'great importance' (scale of 5), while another 17 rated it 'importance' (scale of 4). Only 2 respondents gave a rating of 'moderate importance' (scale of 3) (See Table 6.15.1 below).

Table 6.15.1: Intended Purpose of Loan

Scale	Frequency	Per cent	Cumulative per cent
Great importance	21	52.5	52.5
Importance	17	42.5	95.0
Moderate importance	2	5.0	100.0
Total	40		

The results indicate that intended purpose of loan was the most critical aspect in evaluating the small business proposition. The bank managers were concerned that the small business customers may use the loans for purposes other than was originally intended. From their experience, most of the defaulted loans were due to the inability of the small borrowers to use the money wisely (Boocock & Shariff, 1994). However, there is a question of desirable purpose from the standpoint of a bank. The banks may have some lists of certain undesirable activities, but there can be no such thing as unalterable lists of sound projects. Therefore, the bankers may consider each applicant based on his or her own merits. This finding also concurs with that of Berry et al (1993b) who argue that the intended purpose of loan is a significant variable in the lending decision. This is because the purpose for which the loan is raised will be influential in assessing the potential risk involved in the lending decision.

Normally, in any small business loan application, the prospective customer may be asked the specific purpose of the loan requested. The bank managers would not grant any loan unless they knew how these funds were to be used. Furthermore, they would want to know whether or not the purpose of loan suits the type of loan requested. For example, a loan to finance the working capital should not be used to purchase fixed assets. One of these managers commented:

"It is vital that the loan taken is for its intended purpose and not otherwise".

In addition, the intended purpose of loan must not contravene the bank's policy, and since each bank may have its own policy, any loan application should comply with the facilities and services offered by the respective banks. As explained by a bank manager:

"The intended purpose of loan is very important as our bank has to ensure that the loan is not used for unproductive purposes such as investment in stocks and shares or properties that will not generate income".

6.3.2 Size of loan relative to the size of business

The second most important criterion in the lending assessment of a small business proposition was the size of loan requested, with an overall mean of 4.45. 18 of the respondents gave a rating of 'great importance', while another 22 respondents gave it a rating of 'importance' (See Table 6.15.2 below). The coefficient of variation of 0.11 also shows a lower diversity of opinion among the respondents when rating this criterion.

Table 6.15.2: Size of Loan relative to Size of Business

Scale	Frequency	Per cent	Cumulative per cent
Great importance	18	45.0	45.0
Importance	22	55.0	100.0
Total	40		

This result indicates that the bank managers were also concerned on the amount of loan requested by the small business customers relative to their business sizes. Similarly, Berry et al (1993b) argue that the size of business will be extremely influential in a lending decision, because it has a dramatic effect on the banker's perception of risk. In a normal loan application, the small business customer may be asked to specify the actual amount needed, and the amount may depend on the intended purpose of the loan and the customer's capacity to repay it. The bank managers mentioned that they did not want to grant any loans or advances exceeding the required amount needed by customers. In addition, there were situations where the customers applied for loans lower than what they really required. In this situation, the bankers may advise the customers to apply for the amount accordingly. Most of the bank managers interviewed mentioned the lack of preparedness on the part of the small business customers when applying for loans.

One of these managers commented:

"I came across so many cases whereby these small businessmen couldn't care less for what or why they were applying for the loans. Some simply gave me figures on how much they want, without realising that their businesses couldn't generate so much income to pay back the loans. There were also cases where the small businessmen came with good business plans for expanding their existing businesses but did not actually know how much to apply for to meet the requirements. Thus, I had to advise them on why such a loan requested was too much or too low when appraising their applications".

6.3.3 Loan activity at other banks

This criterion ranked third in overall importance, with a mean score of 4.28. There was a slight variation in opinions among the respondents: 19 of them gave a maximum rating of 5, 14 respondents gave it a rating of 4, while another 6 gave a rating of 3, or 'moderate importance'. However, there was also one respondent who rated it as 'slight importance' (See Table 6.15.3 below).

Table 6.15.3: Loan Activity at Other Banks

Scale	Frequency	Per cent	Cumulative per cent
Great importance	19	47.5	47.5
Importance	14	35.0	82.5
Moderate importance	6	15.0	97.5
Slight importance	1	2.5	100.0
Total	40		

Loan activity of a customer with other banks can act as a signal on his or her creditworthiness. Since asymmetric information occurs in the assessment of small business customers, the relationships with other banks can assist the bank in determining whether the business is viable and the owner trustworthy. Berry et al (1993b) concur that information from other banks is extremely useful, because knowledge of the small business applicant is likely to be little. If the customer maintains a good relationship with these banks, there is no reason to reject his or her application. On the contrary, if the existing relationships with other banks are in doubt, the bank can ignore his or her application so as so avoid any loan pitfall later. However, some managers mentioned their suspicions of the reason for coming to their banks if it is claimed that the relationship with other banks was good. There may be some other reason for the loan application. One of the methods to obtain an answer is to send an inquiry in the form of a 'status inquiry' to the respective banks or institutions. However, in most cases a bank manager would use his or her own contacts or networking within the banking circles, and the information can be obtained in a matter of minutes by just making a telephone call. It was observed that there seems to be a tacit agreement among the bankers to reciprocate the information on prospective customers, although they are in competition for the same market. In a way, this is good for the industry because it helps to rid the market of potential defaulters.

As one bank manager commented:

"I feel more confidence in assessing a small business customer who has an existing account or facility from other banks. In this case, I can simply pick up a phone and call my colleagues in these banks, and ask them the condition of the account, whether it has been satisfactorily conducted or not. If the answer is negative, I can straight away reject the application. But if the account is good, then I will process it accordingly".

However, this argument contradicts that of Cole (1998), who believes that a banker is unlikely to grant loan to a firm if this firm has existing dealings with other financial institutions. It supports the theory that multiple relationships diminish the value of the private information generated by the potential lender.

6.3.4 Repayment of previous loans

This criterion is ranked fourth in the analysis. The respondents gave a divergence of opinions between a rating of 5 and 3. In addition, there was one respondent who gave a lowest rating of 1 or 'unimportance' (See Table 6.15.4 below).

Table 6.15.4: Repayment of Previous Loans

Scale	Frequency	Per cent	Cumulative per cent
Great importance	17	42.5	42.5
Importance	16	40.0	82.5
Moderate importance	6	15.0	97.5
Unimportance	1	2.5	100.0
Total	40		

The past experience of a small business customer in paying back the loan is critical in determining whether he or she qualifies for a loan. These managers agreed that if the customer had good records of loan repayment, he or she would not have any problem in securing further loan. This finding concurs with the arguments by Diamond (1984), Peterson & Rajan (1994) and Berger & Udell (1995), who advocate relationship banking in minimising the agency problem and cost in dealing with small businesses. If the past experience with this customer is positive, the banker may expect the loan to be less risky, and thus the likelihood of granting it will be higher.

As stated by a bank manager:

"I always look at previous records of any customer who comes to apply for a loan. If this customer does not have any record with us, it may be a bit difficult to assess him or her. But if he or she already maintains an account with us and the record shows that its conduct is satisfactory, it will be taken into consideration in determining the repayment capability of the new loans. Furthermore, the previous

repayment record may also indicate the ability of the customer to manage his or her business".

Diamond (1989) also contends that borrowers who default in loan repayments may be denied access to a loan thereafter. The bankers may therefore find the quality of borrowers will improve, because potential defaulters are easily identified and eliminated in the process of making a decision.

6.3.5 Type of business activity

The fifth-ranked criterion is the type of business activity the small business customer is in. The diversity of opinion is slightly lower, with 14 respondents who rated it 'great importance', 19 rated it 'importance', and another 7 respondents who gave a rating of 'moderate importance' (See Table 6.15.5 below).

Table 6.15.5: Type of Business Activity

Scale	Frequency	Per cent	Cumulative per cent
Great importance	14	35.0	35.0
Importance	19	47.5	82.5
Moderate importance	7	17.5	100.0
Total	40		

This is another criterion in which the bank managers found importance in assessing small business propositions. In general, the nature and prospects of the business of the borrowers are tied to the economic conditions. The bank managers may only finance those businesses that meet the bank's policy or certain guidelines issued by the central bank. They may not be willing to finance those businesses they perceive as high risks. The central bank had also directed that certain activities deemed as priority sectors or classified as productive should be given priority by the banks. Not all banks have similar policies. There are also banks that do not consider at all new venture financing, while some banks may be willing to take more risks with new ventures. Some banks are aggressive, and some may be more conservative. But the nature of activity that a customer wants to be involved in determines whether or not a banker may want to consider it for financing.

As explained by a bank manager:

"It is important that the customer comes with a proposition of a business that has a long term prospect. I am not going to finance those who simply jump into the wagon because others are also doing the same thing. And I am also not willing to give loans to those industries that are already in the sunset such as mining, or in a current situation, property development. The customer must therefore know the viability of the business he or she ventures into before coming to my bank".

6.3.6 Gearing

Gearing is ranked sixth with a mean of 4.15. 12 respondents gave a rating of 'great importance', 22 rated it 'importance', while another 6 respondents gave it a rating of 3 or 'moderate importance' (See Table 6.15.6 below).

Table 6.15.6: Gearing

Scale	Frequency	Per cent	Cumulative per cent
Great importance	12	30.0	30.0
Importance	22	55.0	85.0
Moderate importance	6	15.0	100.0
Total	40		

The bank managers would look unfavourably at those small businesses with large debt ratio in relation to their capital. They may not be willing to consider the loan if these customers had a substantial amount of previous borrowings. The bank managers would consider themselves vulnerable, because these businesses had to allocate a substantial portion of income for principal and interest payments on the loans. Further loans may aggravate the situation by putting additional strain on interest payments.

As commented by a bank manager:

"Our standard evaluation of a customer's gearing ratio is 2:1. We normally don't go beyond that simply because it is against our bank policy. Furthermore, we must also adhere to the Bank Negara's (central bank) directive disallowing commercial banks from granting a loan exceeding a certain per cent of the customer's capital at any one time. That's why we are quite strict in this aspect".

6.3.7 Trade debtors

This criterion was also given a relatively high ranking in the lending assessment of small business propositions. Of the 40 respondents, 9 rated it 'great importance', 24 'importance', and another 7 gave a rating of 'moderate importance' (See Table 6.15.7 below).

Table 6.15.7: Trade Debtors

Scale	Frequency	Per cent	Cumulative per cent
Great importance	9	22.5	22.5
Importance	24	60.0	82.5
Moderate importance	7	17.5	100.00
Total	40		

This finding indicates that bank managers were also concerned on how the small business transactions were conducted, especially when it comes to credit sales. High debtors can be attributed to poor collection records on these businesses. It can also be due to over-aggressive strategy to get more sales. The bankers would want to know the past experience of the business in collecting debts. The bank managers were also interested to know the types of clients these businesses were dealing with. The type of business conducted by the clients will guide the bankers in deciding what proportion of the debtors may safely be regarded as good in event of failure. The success of a business and its ability to repay the debt to the bank hinge on maintaining a favourable relationship with its clients.

As commented by a bank manager:

"We want to know whom this business is dealing with. Is this market limited, restricted or competitive? The nature of the market should not be confined to just a small group of dominant customers. The credit policy should not be too relaxed, and if possible try to get cash sales. If this business has a problem in its debt collection, how does it expect to repay its bank loan?"

6.3.8. Repayment schedule

The schedule of loan repayment was ranked eight. There was a relatively wider range of diversity of opinions among the respondents. 13 of them rated it 'great importance', 17 gave a rating of 'importance' and another 9 rated it as 'moderate importance'. There was also one respondent who gave a lowest rating of 1 or 'unimportance' for this criterion (See Table 6.15.8 below).

Table 6.15.8: Repayment Schedule

Scale	Frequency	Per cent	Cumulative per cent
Great importance	13	32.5	32.5
Importance	17	42.5	75.0
Moderate importance	9	22.5	97.5
Unimportance	1	2.5	100.0
Total	40		

It can be said from this finding that the bank managers were also looking at the manner of how a loan had to be repaid. While most of the loans granted were amortised or repaid on a monthly basis, there were situations where repayments could be made on certain occasions or progressively. Thus, a schedule of repayment could assess the ability of the borrower to pay back his or her loan in the future.

One bank manager gave this comment:

"If a customer comes with a good business plan, we can see the repayment schedule of principal and interest in the cash flow. Obviously, it helps the customer in his or her planning, and from a banking point of view the ability of this customer to repay the loan. But we always advise our customer that we would prefer a shorter term commitment".

6.3.9 Trading experience

This criterion had also been ranked as of importance with a mean of 4.00. 7 respondents gave a rating of 'great importance' while 27 rated it as 'importance'. A further 5 respondents gave a rating of 'moderate importance', and another respondent gave it 'slight importance' (See Table 6.15.9 below).

Table 6.15.9: Trading Experience

Scale	Frequency	Per cent	Cumulative per cent
Great importance	7	17.5	17.5
Importance	27	67.5	85.0
Moderate importance	5	12.5	97.5
Slight importance	1	2.5	100.0
Total	40		

An importance placed on this criterion indicates that the bank managers would want the small business to be operated by competent people. One indication of this competence is the experience of the owner or management. From these managers' point of view, only those who had similar experience in the business can be trusted to run a viable business, and hence have the ability to pay back the loan. This concurs with the finding in the preceding section of this chapter that mentioned the experience of the owners/directors influenced the bank manager' decisions to accept or reject the proposition.

As commented by a bank manager:

"Experience in the business is critical to any loan applicant. He or she should be well versed with the business he or she is involved. The ability to pay back the loan relies on the people managing the business to make it a success. Otherwise, the business will suffer, and the bank definitely would not like to be involved with this kind of people".

However, the studies by Deakins & Hussain (1994) and Fletcher (1995) found trading experience was ranked as the most important criterion in the lending assessment of the small business proposition. They remarked that the people involved in the business, and their track record and abilities, are critical, because the success of the business depends on them.

6.3.10 Existing profitability

This criterion shared a joint ranking of 9, with an overall mean of 4.00. 8 of the respondents gave a rating of 'great importance', followed by 24 respondents with a rating of 'importance', and another 8 respondents giving a rating of 'moderate importance' (See Table 6.15.10 below).

Table 6.15.10: Existing Profitability

Scale	Frequency	Per cent	Cumulative per cent
Great importance	8	20.0	20.0
Importance	24	60.0	80.0
Moderate importance	8	20.0	100.0
Total	40		

This finding further indicates that the bank managers were interested in financing those businesses that have been in existence, rather than new ventures. The existing profitability reflects the true position of the business, rather than projected figures. This augurs well with the conservative nature of most bankers preoccupied with risk, and who would only lend if more knowledge and information on the customer were obtained.

As explained by one of the bank managers:

"It is rather difficult for us to consider a loan application if the customer cannot provide sufficient evidence that the business is viable and that he or she can repay the debt within the stipulated period. Maybe the business plan can show it but it is

only on paper. If this customer has been operating a business, and the track record such as profitability is good, then it is easier for us to process it".

The criteria below were ranked as being of moderate importance (overall mean of less than 4.00 but above 3.00) in influencing the lending decisions on the small business propositions. Most of them were related to the availability of financial information which the bank managers could use to assess the risk involved in lending decisions.

6.3.11 Equity stake in business

With an overall mean of 3.95, this criterion was ranked eleventh among the most important criteria in decisions on lending to small businesses. 10 respondents gave a rating of 'great importance', another 18 rated it 'importance', while 12 more respondents gave a rating of 'moderate importance' (See Table 6.15.11 below).

Table 6.15.11: Equity Stake in Business

Scale	Frequency	Per cent	Cumulative per cent
Great importance	10	25.0	25.0
Importance	18	45.0	70.0
Moderate importance	12	30.0	100.0
Total	40		

The bank managers were also looking at the contribution of owners or shareholders to the business, and they would not be willing to finance any venture which relies wholly or for most of its funding on external sources. If the contribution from the owners or shareholders is substantial, it shows a commitment on their part in ensuring the viability and success of the business venture. Thus, the bankers may be more comfortable to finance those businesses where the owners' stake was high. As commented by a bank manager:

"It is important that the directors, partners or owners have an equity stake in the business so as to avoid dispute later on. We also want to know whether the applicant has a major share or just simply a proxy in the business. We don't like dealing with sleeping partners or somebody who let others use his or her name".

6.3.12 Trade Creditors

This criterion was ranked twelfth in the order of importance in the decisions on lending to small businesses. 7 of the respondents gave a rating of 'great importance', 22 gave it a rating of 'importance', and another 11 respondents rated it 'moderate importance' (See Table 6.15.12 below).

Table 6.15.12: Trade Creditors

Scale	Frequency	Per cent	Cumulative per cent
Great importance	7	17.5	17.5
Importance	22	55.0	72.5
Moderate importance	11	27.5	100.0
Total	40		

The relatively high percentage of ratings of between 4 and 5 (72.5%) means that the bank managers were equally concerned with the manner in which the small businesses conduct their transactions with the suppliers. Does the business take advantage of the availability of trade discounts? Failure to do so can give a sign of financial weakness or poor financial planning, because it may be paying an extremely high rate for the capital provided by its suppliers.

A comment given by a bank manager:

"If a firm obtains its supplies on credit, it makes sense in business but I want to know how much and how long the payments are in arrears. If it cannot maintain good payment records, then I am going to face trouble later if I approve its loan application. Obviously, I'll check first the credit rating with its creditors".

6.3.13 Net profit to sales

This criterion was ranked at thirteenth, relatively lower than existing profitability at ninth. Seven of the respondents gave a rating of 'great importance', 21 gave it a rating of 'importance', and another 12 respondents gave a rating of 'moderate importance' (See Table 6.15.13 below).

Table 6.15.13: Net Profit to Sales

Scale	Frequency	Per cent	Cumulative per cent
Great importance	7	17.5	17.5
Importance	21	52.5	70.0
Moderate importance	12	30.0	100.0
Total	40		

The table shows that the bank managers were looking more at the actual performance of the applicant's business rather than the financial ratios. This finding could reflect that the bank managers interviewed were relying less on the financial information and the analysis when deciding on the loan application from the small businesses.

As commented by a bank manager:

"We normally don't use ratios in our assessment, and if we do, it depends on the type of business. The bank has its own ratio for each type of business. But, we also don't take it seriously because the customer can simply inflate the figures".

6.3.14 Projected income

This criterion came fourteenth in the order of importance. There was a relatively wider divergence of opinion among the respondents, with 10 of them giving a rating of 'great importance', 16 rated it 'importance', and another 11 respondents gave a rating of 'moderate importance'. There were also 2 respondents who gave a rating of 'slight importance', while one respondent gave it as 'unimportance' (See Table 6.15.14 below).

Table 6.15.14: Projected Income

Scale	Frequency	Per cent	Cumulative per cent
Great importance	10	25.0	25.0
Importance	16	40.0	65.0
Moderate importance	11	27.5	92.5
Slight importance	2	5.0	97.5
Unimportance	1	2.5	100.0
Total	40		

The finding further indicates that the availability of financial information was not a major factor in the decisions on lending to small businesses. Most of these bank managers were not enthusiastic or did not show an interest when presented with projected financial statements. This concurs with the earlier findings where most bank managers were suspicious of projected figures and complained of unrealistic figures quoted to them or prepared without the basis or consideration of the actual business or conditions in the industry.

One of them commented:

"Projected figures don't influence my lending decisions. They look nice on paper but usually are not reliable. Anybody can come out with projected figures, and you can even pay a consulting firm to do it for you. What we are interested in is actual figures that show a true picture of the business".

6.3.15 Liquidity Ratios

This criterion was also ranked lower in the order of importance, at fifteenth. 8 respondents gave a rating of 'great importance', and 17 gave it a rating of 'importance'. Another 13 respondents rated it as 'moderate importance', while 2 gave a rating of 'slight importance' (See Table 6.15.15 below).

Table 6.15.15: Liquidity Ratios

Scale	Frequency	Per cent	Cumulative per cent
Great importance	8	20.0	20.0
Importance	17	42.5	62.5
Moderate importance	13	32.5	95.0
Slight importance	2	5.0	100.0
Total	40		

It should be noted that a significant number of the bank managers gave a 'moderate importance' for the use of liquidity ratios in their lending assessments. While liquidity is critical in determining the ability of a business to repay the debt, it was not the major factor in influencing the lending decisions on the small business propositions. It was also revealed in the earlier findings that only a small number of bank managers attempted to analyse the proposition using an analytical tool such as the ratio analysis.

As explained by one of the bank managers:

"We use what available tools we have in our assessments, and ratios are one of these many tools. It helps in our assessment, but let's be frank. Can the ratios tell us that

a particular person or firm can repay the debt in future? I'm saying I don't believe in them because they tell you only 30 per cent of the story".

6.3.16 CVs of Clients

This criterion was also given a lower ranking order, at sixteenth. Only 4 respondents gave a rating of 'great importance', while 21 gave a rating of 'importance', and 13 rated it 'moderate importance'. Another 2 respondents gave a rating of 'slight importance' (See Table 6.15.16 below).

Table 6.15.16: CVs of Clients

Scale	Frequency	Per cent	Cumulative per cent
Great importance	4	10.0	10.0
Importance	21	52.5	62.5
Moderate importance	13	32.5	85.0
Slight importance	2	5.0	100.0
Total	40		

This finding indicates that the credentials of the small business applicants were not sufficient enough to influence the lending decisions. Notwithstanding, those with good educational background coupled with previous experience in the related field may stand a better chance to secure loans from the banks. The findings in the earlier section revealed that the credentials of the owners/directors might be an important factor on the decision to accept or reject the loan proposition. As stated by a bank manager:

"The first thing I would look and would like to know is the people who run the business. How experienced and capable they are? Are they the right people? Maybe they are professionals and have good qualifications, but can they manage the business?"

6.3.17 Availability of Collateral

This criterion was also ranked lower, at seventeenth. However, there was a wide diversity of opinions amongst the respondents. 8 gave a rating of 'great importance', another 12 a rating of 'importance', and a further 14 respondents a rating of 'moderate importance'. There was also a rating of 'slight importance' given by 6 respondents (See Table 6.15.17 below).

Table 6.15.17: Availability of Collateral

Scale	Frequency	Per cent	Cumulative per cent
Great importance	8	20.0	20.0
Importance	12	30.0	50.0
Moderate importance	14	35.0	85.0
Slight importance	6	15.0	100.0
Total	40		

This finding concurs with those in the literature which show that collateral should not be a primary consideration in the lending assessment, but act as a secondary source of repayment in the event of default. Collateral normally involves pledging of assets outside the firm or business, typically belonging to the owner or owners. One of the bank managers clarified:

"In my assessment, collateral is not the main concern, but what I want to now is whether the business is going to be viable or not".

However, this finding is somewhat surprising in that it appears to contradict the preceding section that found 'lack of collateral' to be the main reason for rejecting the business proposition. One plausible interpretation may explain this apparent contradiction. These managers may have perceived the business proposition to be relatively risky because of a 'new venture', while for an existing business with a better track record, collateral may become less of a primary consideration to them.

But collateral can also signal the quality of a business proposition, and is now a common feature used in the lending contract by banks to mitigate the asymmetric information problem. Berger and Udell (1998) argue that collateral is a powerful tool that allows banks to offer loans on favourable terms to small businesses whose informational opacity might otherwise result in either credit rationing or the extension of loan only on relatively unfavourable terms.

6.3.18 Charge on Assets

This criterion was ranked in similar order of importance (seventeenth) to availability of collateral, but its coefficient of variation was relatively smaller. 4 of the respondents gave a rating of 'great importance', followed by 18 with a rating of 'importance', and 14 with a rating of 'moderate importance'. Another 4 respondents rated it 'slight importance' (See Table 6.15.18 below).

Table 6.15.18: Charge on Assets

Scale	Frequency	Per cent	Cumulative per cent
Great importance	4	10.0	10.0
Importance	18	45.0	55.0
Moderate importance	14	35.0	90.0
Slight importance	4	10.0	100.0
Total	40		

Charge on assets involves pledging assets owned by the firm or business. This criterion was given a lower ranking by the bank managers because of the difficulty with which these assets could be sold in case of liquidation. A business may have also pledged its assets for other commitments prior to approaching the bank for a loan and, as a consequence, the bank may find itself unable to dispose of them.

As commented by a bank manager:

"It is a normal banking practice to accept a charge of assets of a firm or company for repayment of loans. But we accept it as an added security and not as a main collateral unless the firm or company is well established and highly reputable. Furthermore, we would prefer fixed charge than floating charge, and the assets should not have been pledged before".

This concurs with the argument put forward by Avery, Bostic and Samolyk (1998) who contend that pledging of assets is generally viewed as credit enhancement that reduces the risk of lending. Although to a certain extent it mitigates the loss exposure of lenders, it appears to be a complementary arrangement for a collateral.

6.3.19 Length of Time Doing Business with Bank

This criterion was second lowest at nineteenth in the ranking order of importance. 2 of the respondents gave a rating of 'great importance', 18 'importance', and another 18 'moderate importance'. There were also 3 respondents who rated it as 'slight importance' (See Table 6.15.19 below).

Table 6.15.19: Length of time doing Business with Bank

Scale	Frequency	Per cent	Cumulative per cent
Great importance	2	5.0	5.0
Importance	17	42.5	47.5
Moderate importance	18	45.0	92.5
Slight importance	3	7.5	100.0
Total	40		

Surprisingly, this criterion was considered to have a low rank of importance in the decisions on lending to small businesses. This contradicts previous findings that maintaining a continuing favourable relationship with a customer can increase the likelihood of that customer obtaining a loan from the bank (Diamond, 1984; Boot & Thakor, 1994; Berger & Udell, 1995).

As explained by a bank manager:

"It is easier to process if the applicant is our existing customer, but it is not a passport to getting the loan. He or she must also undergo the rigour of our appraising, and if he or she qualifies then it is worth the effort. Nevertheless, I would still prefer handling people whom I know in my appraising work".

Berry et al (1993b) insist that if the applicant is an existing customer, it will greatly help a banker in assessing the risk associated with a lending proposal. Furthermore, the banker will have more knowledge of the person and the person's business, a critical factor in a small business where the success of the business is so clearly linked with the business attributes of the owner. Meyer (1998) also argues that since asymmetry of information occurs in small businesses, bankers can effectively gain valuable information over the course of the relationship, and then use this information to help make decisions. But this finding concurs with that of Cole (1998) who argues that a potential banker is more likely to extend loan to a firm with which it has a pre-existing relationship, and that the length of this relationship is not important.

6.3.20 Government Guarantee of Loan

This criterion came last in the ranking order of importance. However, there was a relatively wide diversity of opinion amongst the respondents. 2 of them gave a rating of 'great importance', 15 'importance', 15 'moderate importance', 6 'slight' importance', and another 2 gave a rating of 'unimportance' (See Table 6.15.20 below).

Table 6.15.20: Government Guarantee of Loan

Scale	Frequency	Per cent	Cumulative per cent
Great importance	2	5.0	5.0
Importance	15	37.5	42.5
Moderate importance	15	37.5	80.0
Slight importance	6	15.0	95.0
Unimportance	2	5.0	100.0
Total	40		

The finding may imply that the establishment of the Credit Guarantee Corporation (CGC) schemes and the availability of government-funded funds to assist the small business sector seemed to have no direct impact as far as loan decision-making is concerned. This perhaps explains the relatively small amount of loans being approved under the CGC scheme, and a slow disbursement of specially created funds, discussed earlier in Chapter Two. Several explanations may be given for this low rating. The bank managers may perceive that the guarantee does not reduce the costs of appraising. Such costs have been identified as the factor in explaining the reluctance of bankers to lend to small businesses (Boocock & Shariff, 1994). Furthermore, the government cannot influence the attitude or ability of the borrower to repay the debts. In addition, there is a mistrust of the manner the CGC handles the recovery of claims forwarded by the bankers.

As commented by a bank manager:

"The CGC did help in minimising the risk, but it is not crucial in influencing my decision making. The problem with CGC is that it has a bad track record in recovering default payment. Even then, when CGC guarantees only 70 per cent of the loan, it is too bureaucratic and taking too much time to get it refunded".

It was pointed out in the preceding section that most bank managers had reservations on the CGC or the many special loan schemes provided by the authorities to assist the small businesses. Previous studies have also shown that most of the government-backed schemes did not have much influence in lending to the small businesses (Ulrich & Cassell, 1974; Jones, 1982). Deakins & Hussain (1994) found that most managers considered government-backed schemes as marginally important to a lending decision, while NERA (1990) found them useful, but only in a 'last resort' role. However, a study by Fletcher (1995) revealed that about 84 per cent of Scottish bank managers favoured the schemes, although they were used fairly infrequently. A majority of the managers gave positive responses to the government-backed schemes in assisting the small businesses.

Looking back at the criteria ranked by the bank managers, an interesting feature is worth noting. Those criteria with a mean of 4.00 and above are mainly related to past or existing business activities, which means that bank managers would give more weighting to established businesses rather than new ones. This seems to concur with the reluctance of most bankers to give a positive response to the business proposition, as revealed in the earlier section of this chapter. As a newly set-up business with no track record, there was a cause of concern among the bankers on its ability to repay the loan. This probably explains the low ratings given to criteria such as projected income and availability of collateral, which are normally associated with new ventures.

Generally, the fundamentals of lending, such as safety, suitability and profitability, are applied in the decisions by bank managers in Malaysia on lending to small businesses. That a loan must be granted to a prospective borrower who can repay within a stipulated period, and also generate acceptable returns to the bank, remains undoubted. However, these banks operate in an imperfect market because of information asymmetries, where the small business owner generally has much better information than the banker, and this leads to the problems of adverse selection and moral hazard. Thus, the major task in the bank lending decision is to overcome the asymmetric information problem in order to reduce or avoid credit risk. Hence, the focus of the decisions by these bank managers seems to be mainly on the expected risk of the loan. It also appears that the preoccupation with risk is the single most important factor in the lending decision, rather than the expected returns from the loan.

CHAPTER SEVEN

7. CONCLUSIONS, IMPLICATIONS AND SUGGESTIONS FOR FUTURE RESEARCH

7.1 CONCLUSIONS

7.1.1 Introduction

The purpose of this chapter is to draw together the findings of the study, and to throw some light on the main research questions and research methodology that form the basis of the thesis.

This study was undertaken to investigate the lending decisions of bank managers in Malaysia when assessing small business propositions. Its aim was to examine the inadequacy in the decision-making process of bankers that may contribute to the 'finance gap' in the availability of funds to the small business sector. The investigation also aimed to identify the relative importance of criteria used in evaluating the small business loan proposition, and to understand the attitude and behaviour of the bank managers in dealing with small business customers. This chapter will provide suggestions on how the findings can be used to improve our understanding of the bankers' lending decisions, and on how they can help the bankers, small business entrepreneurs, and policy makers in improving the availability of bank finance to the small business sector.

It was noted in the earlier chapters that the 'finance gap' for the small business sector was by no means unique to the industrialised countries. Evidence suggests that the 'finance gap' exists too in developing countries, and many small businesses were finding it difficult to acquire bank loans. However, there was a dearth of literature on bank lending decisions on small businesses in the developing countries, and this prompted the researcher to conduct the study. Malaysia was chosen, not only because of its familiarity as a home country to the researcher, but also as it is one of the emerging economies among the developing countries that recognises the contribution of the small business sector to the economy. It was also acknowledged that the sector would act as a catalyst to the process of industrialisation by complementing the larger manufacturing industries. There was a growing concern that the presence of the 'finance gap' will have an adverse effect on the growth and survival of small businesses, thereby impairing the ability of the country to achieve the developed economy status by the year 2020. Therefore, this study will not only contribute to the understanding of the issue, but also allows the researcher to add breadth to the body of literature by providing a comparative finding with previous research.

In Chapter Five, a detailed review of the research methodology was discussed, and the rationale for adopting a qualitative interview technique for this study was presented. The selection of the research design was based on the need to have an in-depth investigation to understand fully a bank manager's decision-making process. Previous researchers have uncovered the paucity of in-depth studies on similar issues. However, a number of methodological shortcomings were identified among those studies. Therefore, to understand the lending decision of a bank manager on the small business proposition, it was desirable to observe the process in a realistic or close to an actual situation as possible. The methodology involved the use of a real business proposition to gather the required information.

A total of 40 bank managers participated in the study. They were selected from the northern region of Malaysia, and were interviewed in the course of the researcher's fieldwork. The selection of the sample was a mixture of purposive and random sampling. This sampling technique is advocated by a number of researchers who argue that it will substantially increase the quality and credibility of results. The interviews were conducted with the aid of questionnaires, and both quantitative and qualitative data were obtained. The quantitative data were obtained from the structured questions used in the interviews. It was also argued that the use of a structured form of questionnaire should be encouraged when there is detailed relevant knowledge available, and when there is a desire for data that would be explicitly comparable with other studies. However, the use of these data served mainly as a complementary tool to the qualitative approach taken in this study.

7.1.2 Findings and Discussions

The findings were grouped into two major parts, with each part focusing on similar issues, but from a different version of questionnaire. The central idea of separating the questionnaire was that the researcher was likely to acquire a better understanding of a bank manager's lending decision process when assessing both the new ventures and the existing small businesses.

The first part of the questionnaire was specifically aimed at understanding how bank managers make decisions when presented with a small business proposition. In so doing, the study also focused on the attitude, perception and behaviour of these bankers when dealing with small businesses. The findings revealed the conservative attitude on the part of Malaysian bank managers when deciding on lending to small businesses. Most of them took a cautious approach, especially when confronting with new ventures. About half of the bank managers surveyed rejected the proposition, while another 15 per cent deferred the decision. The main reason given for rejecting the proposition was a lack of collateral, followed by new venture, no track record, inexperienced and unknown directors, and against bank policies. A number of them gave outright rejections because of perceived risk that is commonly associated with small businesses. This finding seems to be consistent with decisions of bankers in the developed countries. One plausible explanation for this attitude was the asymmetry of information that is also associated with the small businesses in Malaysia. However, when a number of them also mentioned the bank policy of not entertaining the new ventures, this should be a cause of concern to the banking industry. These banks had set-up small business units at their head offices to cater for both new ventures and existing small businesses, and the finding may imply that this policy was not fully implemented at the branch level.

The reason given for accepting the proposition was mainly on the seeming security of the loan, based on a guaranteed income to be assigned directly to the banks. Although a number of them also mentioned the guarantee provided by the CGC, it was not the main criterion in accepting the proposition, and the CGC was treated merely as complementary to other security requirements. The managers who deferred the decision were held back by 'insufficient information', which according to them was vital for the decision. These findings therefore revealed a largely collateral-based lending approach taken by the bankers when dealing with small business customers. Perhaps this could also be the reason why some small businesses in Malaysia have difficulty gaining access to bank loan.

It also emerged from the findings that there was no uniformity in the decisions with regard to identical business propositions, and the lending policies pursued by individual bank managers were inconsistent. They revealed the complex and multifaceted nature of a bank manager's decision-making behaviour. This concurs with the literature that the process of making a decision is not a straight-forward procedure, but is full of complexities and uncertainties as well as being influenced by a variety of disciplines (Harrison, 1981; Barona, 1985; Kreitner, 1997). These forces of influence, such as values and ethics, attitudes, personality and perceptions, may have caused considerable variations in the approach taken by these bank managers in making decisions. A bank manager may perceive a particular situation in a very different way from another manager, because the way he or she sees the situation is coloured by his or her own particular needs, background and experiences. Furthermore, the manager's decision-making is frequently constrained by imperfect information, time and cost factors, and severe cognitive limitations. Within an organisation, his or her decision is often bounded and biased by 'rationality', and the choice is constrained by the desire to minimise uncertainties. In addition, many decisions by bank managers in Malaysia were made in circumstances where outcomes were uncertain, and they sometimes made a judgement in respect of probability without the aid of objective measures. None of them claimed to have used or employed a highly formalised quantitative model or credit-scoring system in their lending decisions on small businesses.

The inconsistency in the decisions could also imply that the guidelines issued by the head offices were not fully implemented by the bank managers. Although a majority of them mentioned the use of standard form and a check list to assess the proposition, these managers may have their own discretion as to how to assess it. This explains the employment of largely intuitive judgement because they strongly believe that it helps them in coming up with correct decisions. The main drawback here is that heuristics could lead to serious errors in judgements, and therefore, a possibility of biases in lending decisions on small businesses. When the bank managers mentioned the avoidance of Type I errors, it concurs with Deakins & Hussein (1994), because the outcome would not have affected their performance. However, there should be a cause of concern when a significant number of managers expressed their dissatisfaction with the approval authority at the office level, because it would affect their morale and performance at work.

The findings have also identified a number of attributes that determined the acceptance or rejection of the small business proposition. Those who had been in the banking industry for a relatively longer period tended to be more conservative and cautious in their lending approach to the small business customers. There was also a tendency among graduate bank managers to employ a more systematic or quantitative approach than those managers who had no university or college qualifications. In addition, these bank managers also employed a mainly 'gone concern' approach in the analysis of quantitative information, and this indicates that they seemed to follow a relatively conservative decision on lending to small businesses. Given this approach it would be hardly surprising if the banks were reluctant to finance longer-term loans, where it would incur considerable risk and higher monitoring costs. The findings also revealed that smaller banks were more willing to lend to the small business sector compared to bigger banks. This should have an important policy implication in the wake of a consolidation exercise undertaken by the government on the banking industry in Malaysia through mergers and acquisitions. It appears that the findings of this study support most of the findings from previous works, and in general, reveal many of the problems common to the bankers in developed countries.

The second part of the questionnaire identified the relative importance of criteria used in assessing the small business loan proposition, both for new ventures and existing businesses. The bank managers ranked intended purpose of loan, size of loan relative to size of business, loan activity at other banks, and repayment of previous loans as the top criteria in their assessment. On the other hand, the government guarantee of loan, length of time doing business with the bank, charge on assets, and availability of collateral were given the lowest ranks in terms of importance. This finding indicates that the bank managers were preoccupied with risk when dealing with small business customers. This is not surprising, because banking business like other business concerns seeks to make profit, and lending to small businesses is always perceived to be a risky venture. Furthermore, they operate in an imperfect market where asymmetry of information occurs, and this leads to the problems of adverse selection and moral hazard.

NERA (1990) identifies the two types of risk that are commonly associated with small business lending. The first risk is that if the business fails, the bank will need to realise its security. The second is where the security taken will be insufficient to cover the losses from the loan defaults. Therefore, this preoccupation with risk, perhaps, may have contributed to the reluctance of some bankers to commit funds to small businesses, even in some circumstances where they were accompanied by collateral or guarantee. This was reflected in the findings, where the availability of collateral or guarantee seemed to have no impact as far as the lending decision was concerned. This should also be a cause of concern to the relevant authorities, because there seemed to be a lack of trust in the CGC and all other schemes sponsored by the government.

Generally, there seemed to be a lack of real understanding of the framework and financial viability in which the proposition was introduced and presented. The bank managers considered the business proposition from the point of view of a potential risk of loan default rather than future viability of the business or project. This explains the employment of a mainly 'gone approach' among the bank managers when analysing the financial information. This approach focuses on how a loan would be repaid if the business fails rather then the future prospects of the business itself.

It can be seen that the bankers have been more successful in developing a real understanding of the borrower's capacities in larger firms, and trying to emulate similar methods with small businesses can lead to bias and errors in judgement. This problem may also be attributed to a lack of qualified personnel who truly understand the nature of small businesses and/or the small business customers, especially those pertaining to new ventures. Although the banks have a long tradition of professionalism, well-established staff, and common approach to training, it is apparent that in respect of small business lending, the assessment was somewhat inflexible and insensitive. They also tend to treat the small business sector as a single entity, although evidence shows that it is not homogeneous.

The findings further revealed not only the difficulties of these bankers in dealing with small business customers, but also the true nature of some of them, especially in regard to perception of risk and requirements of collateral as a basis for loan consideration. There were also some attitudinal factors such as lack of interest or enthusiasm when dealing with small businesses. These bankers also did not show any keenness to develop a long-term relationship with the small business customers, which would have provided them with vital information on the viability of the sector. Inevitably, their approach to lending assessment tend to be more 'generalist' than 'specialist', and this may have contributed to the problems of adverse selection and moral hazard. Perhaps, bank managers are not trained to be specialists, because traditionally they are responsible for all activities at the branch level. While these managers are generally very experienced bankers, they may be lacking in some aspects of lending assessment, such as in the case of small business customers.

There was also a problem of attitude among some of the 'older' bank managers. These bankers may have an old-fashioned view of what a banker is and should be doing. They were also content with what they have achieved in their career, and seemed reluctant to venture into somewhat untested areas. Although the idea of increasing loans to the small business sector has received general acceptance in principle by the banks, it has yet to achieve an understanding by these managers. Old habits and attitudes die hard, and some of these managers may even not accept or 'genuinely' understand, or just pay 'lip service' to their banks' requirements. These problems may also be attributed to the banks' practices of 'exiling' non-performing staff to head some branch office, where they are not given enough authority to make decisions.

It is often argued in the literature that an asymmetry of information can lead a bank to an excessive caution when assessing the loan proposition from the small business. This in turn causes harmful under-financing to the sector. This lack of information is further exacerbated by a gap between the bankers and the small business owners. This gap is caused by indifferent attitudes among some of the bankers, who sometimes perceive small business owners as a potential portfolio of non-performing loans, and thus are reluctant to help them. The bankers, therefore, need to discard their attitudes, and instead focus more on understanding the small business sector and work out procedures for channelling required funds to it. They can obtain valuable information through monitoring the operations of the small business borrowers. This helps in building up knowledge of the small business borrowers, and their potential for viable funding.

The findings of this study suggest that the prevalence of inadequacy of bank finance to the small business sector in Malaysia can be largely attributed to the problems of lending decisions on the part of the bankers. It is also generally accepted that these banks do not totally understand the needs and issues confronting small businesses. As a result, the findings confirm the hypothesis that the process of making decision on lending to small businesses can often lead to a biased judgement. They are reasonably consistent with the existing literature on the issues in developed countries especially those in the UK and the US.

This study has also highlighted the fact that despite efforts being made to increase the availability of bank finance to the small business sector, they have achieved limited success. Unless these problems are rectified, the inadequacy and unavailability of loans to the small business sector will persist, and the government's objective to enhance the development of the sector will remain difficult to accomplish.

7.2 RESEARCH IMPLICATIONS

It is also appropriate to examine how the findings of this study can have some important implications to a number of interested parties, especially the bankers, small business owners and policy makers.

7.2.1 Banking Industry

The fact that the objective of this study was mainly on understanding the issue of bankers' lending decisions, it is justifiable therefore, that the findings should raise some important policy implications to the banking industry.

First, the banking business is becoming more competitive and the environment is constantly changing, and commercial banks may find their traditional markets increasingly tight with decreasing margins. On the other hand, the small business sector is a significant and growing market segment. It now represents an increasingly important source of new business for the banks. If the banks want to reap the benefits of a growing market, they must discard the perceived 'unfriendly' attitudes towards the small business customers.

Second, there is a need for the banks to provide special training for their officers towards understanding the nature and characteristics of small business, especially pertaining to new ventures. There is evidence to show that some banks were reluctant to finance new ventures because of limited knowledge and awareness of these businesses. Maybe the training should also put emphasis on 'reverse seminars' (Maister, 1989), whereby the officers have the opportunity to hear from the small business entrepreneurs about their needs and problems. Such seminars would also provide a forum for the banks to get across the messages on what they expect from the entrepreneurs when applying for loans, thus helping to increase understanding of both parties (Vyakarnam & Jacobs, 1991). Banks in the UK also have consistently seconded staff to organisations such as Enterprise Agencies, where they can see matters 'from the other side of the fence' (Storey, 1994). Alternatively, these banks could work with the local universities to undertake training in how to deal with small businesses. Many banks in the UK, such as the National Westminster Bank, have taken part in courses such as those run by the Durham University Business School, the purpose of which was to enable managers....'to better understand what makes owner-managers tick, and therefore be in a better position to help them, rather than see them purely as series of financial statistics' (DUBS, 1994; Read, 1998).

Third, banks should also make special effort to ensure that heuristic judgements do not bias their officers' decisions on small businesses. It was mentioned that an over-reliance on intuition or heuristic judgement could lead to serious and systematic errors. This in turn means banker turning down a good business proposition which turns out to be a success (Type I error) or a banker accepting a proposition which turns out to be a business failure (Type II error). Therefore, educating officers in a thorough understanding of heuristics is an appropriate way of reducing these biases (Shanmugan & Bourke, 1992).

Fourth, bankers should be encouraged to use the credit-scoring technique to increase consistency and objectivity in their lending decisions. This means a diminished discretion on the part of an individual banker and an increased use of the computer in making decisions. The technique provides a quick and accurate risk assessment of an applicant that assists a bank manager in his or her lending decision. Furthermore, a bank can process larger volumes of small business loan applications with minimum costs and resources. This creates more opportunities for small business borrowers, streamlines the lending process, and allows banks to still be profitable in lending to this sector. However, to adopt the credit-scoring technique in the lending decision is not an easy matter. First of all, it cannot predict with certainty the performance of an individual borrower, although it does provide a method of quantifying the relative risks of different groups of borrowers. Then, there is an apparent lack of an appropriate database of small businesses that contains the historical information needed to estimate the loan default probabilities. Thus, it may be difficult to develop an accurate risk rating, crucial in assessing the creditworthiness of a loan applicant. Nevertheless, this technique is now being used and has proven popular among bankers in developed countries. Thus, it should be considered to be potentially one of the factors that can change the traditional bank lending assessment, and ultimately increase availability of loans for small businesses.

Fifth, more emphasis should be put by bankers on prospects-based income-bearing in loan assessment, as opposed to purely collateral-based lending. This includes adopting a more 'going concern' approach in analysing the financial information. They should focus more on the merits of the business or venture proposed by the small business customer rather than the availability of collateral. To make sure that this suggestion is put into practice, the bankers must have a clearer understanding of the characteristics of small businesses that can survive and grow compared to those that fail to survive (Storey, 1994). In addition, bankers should define small businesses according to sector or characteristics, and not lump them together as a single entity. Evidence suggests that the small businesses are not homogeneous. In addition, the development of the small business goes through the different stages of the business life cycle. The risk and profitability that are inherent in the small businesses varies accordingly. Thus, segmenting a market for a small business customer according to sector, characteristics, stages of growth, etc., should be a major influence in the lending decision of a banker.

Sixth, there is a need for the banks to shift their approach on small business customers to a strategy of maintaining a long-term relationship, or what is known as 'relationship banking' (Goldenberg, 1993; Storey, 1994; Bergevin et al, 1997). This strategy will focus more on financing longer-term loans, and monitoring the operations of the business and the use of loans during the period. This will help in building up knowledge among the bankers on small businesses, and minimising the levels of risk. Storey (1994) also suggests that the main use of short-term overdraft facility in small business financing provides the wrong signals in their relationships because it does not provide the bank with an incentive to monitor the activities of the small business customers.

Seventh, there should be a clear and consistent policy on small business lending by the banks. The policy should also be supported and accepted at all levels of management, especially at branch offices. There is also a need for the banks to overcome a major attitudinal obstacle among some of the senior personnel who still maintain an 'old fashioned' view of a banking business. The banking industry is changing rapidly and the environment is very competitive, and unless the attitude of these officers is changed, it will remain a stumbling block to the availability of finance to the small business sector. The practice of sending officers to the branches as a form of punishment should not be encouraged. The branch offices should be filled with staff who are energetic, extroverted, and with communicative skills. Similarly, the bank managers should not be moved around too frequently, because it destroys relationships with, and the acquisition of knowledge of the small business customers.

Finally, banks should provide a support system that can provide useful services for the small business community. More interactions should be encouraged among the bank branch managers and their personnel with the community, not only to solicit business but also to provide them with information, opinions and support. This practice will provide critical information to the bankers that will also increase the quality of their lending decisions.

7.2.2 Small Business Owners

Clearly, banks are a very important source of external finance for the small business sector, and the importance of this study to the small business owners lies in three main areas:

Firstly, the findings have revealed the various criteria used in assessing the small business loan proposition, and that the decision varies from one banker to another. It is therefore absolutely essential for the small business owners to develop an understanding of the decision criteria used by these bankers, so that the probability of getting loan approval will be greatly enhanced. In addition, it is also necessary for the small business owners to 'shop around' for a particular bank or banker that can offer satisfactory treatment to their loan applications. They should seek advice from other small business owners who might be able to recommend the 'right' bank or banker for the loan.

Secondly, small business owners should be more assertive and well prepared when presenting the proposition. They should be well versed on their proposed projects or businesses, and seek advice in those areas in which they have fewer skills or less experience. Berry et al (1993b) have argued that small business owners who go into the bank with a well prepared business plan, who are confident with their proposal, and who can speak the bank's language are more likely to be offered the finance they require, and to have a more favourable experience of the banking relationship.

Finally, it is importance for the small business owners to maintain close relationship with their banks. Evidence suggests that small businesses should be able to obtain more and cheaper financing by establishing a closer long-term relationship with the banks (Diamond, 1984; Peterson & Rajan, 1994; Berger & Udell, 1995). It is also advisable for the small business owner to concentrate his or her relationship with a single bank (Blackwell & Winters, 1997). This allows the bank to build an information advantage over other bankers. Because of potential competition, the bank's cost saving obtained from the relationship will be passed to the firm in the form of lower interest rates. Furthermore, the firm also benefits from reduced monitoring cost passed by the bank in the form of lower interest rates by placing the business in the less monitored loan class.

7.2.3 Policy Makers

This study addresses an issue that is the subject of considerable debate and concern, not least among the policy makers. Thus, the findings of this study can have several implications to the policy makers in the following way:

First, the importance of the small businesses and the banking sector to the economic development has been recognised. The bank funding is also crucial for the small business sector, and it relies heavily on the bank loans for growth and survival. Therefore, in the interest of the economy there is a need for a closer relationship between the small business owners and the banks. Concerted effort should be made by the authorities upon encouraging dialogue between the two communities so that a number of problems identified in the findings could be overcome. Storey (1994) suggests that the authorities could exert a powerful moral influence in encouraging the parties to trust one another and in being seen to be speaking out against efforts by either side to destroy the build-up of confidence.

Second, the government's decision to consolidate the country's domestic banks into ten larger and distinct banking groups through mergers and acquisition should be a cause of concern for small business lending. The findings suggest that smaller banks tend to give more favourable treatment to small businesses compared to larger banks, and this decision could cause considerable difficulties for small businesses to raise funds. Although previous studies have found that mergers between smaller banks do not seem to reduce small business lending, the authorities should ensure that negative effects do not take place in the domestic banking industry. In addition, necessary action should be taken to fill the lending gap left by banks in some areas as a result of a merger or acquisition.

Third and finally, it seems that the experience of a guarantee scheme and various special funds has not been successful, mainly because of distrust among the bankers. The fact that the guarantee of a loan by the CGC was given a relatively low ranking of importance in a lending decision suggests an urgent need for the government to rethink its role in making funds more available to the small business sector. The guarantee cannot, on its own, overcome the problem. Maybe it should be part of a package that can effectively motivate the banks and overcome their natural reluctance. Perhaps the government could encourage more dialogue between the banks and the relevant agencies, or ask the banks to second their officers to agencies such as CGC and SMIDEC, as was done in the UK. This could provide them with a heightened awareness of the problems faced by small businesses.

7.3 SUGGESTIONS FOR FUTURE RESEARCH

There are a number of questions that this study could not answer with certainty due to methodological limitations, and resource and time constraints. However, despite these limitations, the study has generated insights that increase a fund of knowledge on understanding the process of making loan decisions that will contribute positively to bankers, small business entrepreneurs and policy makers. This study has also identified a number of areas that can be seen as an agenda for further research.

First, there is a need for additional research to validate this study. It was noted at the outset that the study was undertaken because of the paucity of similar research in the developing countries. Maybe similar research in another developing country should provide a good comparison with this study. The findings of this study have also identified a variety of factors that are crucial to the lending decisions of bank managers. To emphasise further the impact of these relationships, further research for the purpose of validating the results is needed.

Second, throughout this study, a business plan was used to understand the process of making lending decisions among the bank managers. However, it was impossible to eliminate entirely the effects of artificiality of the situation because the researcher himself is not a 'real' entrepreneur. Other methods such as protocol analysis or repertory grid techniques could perhaps be employed to understand truly these lending decisions.

Third, this study has opened the door to additional research effort that will serve to generalise the findings to the whole banking industry. Follow-up studies should perhaps explore a comprehensive strategy by generating samples large enough to investigate fully the research problems identified in this study.

Fourth, this study also raises an important question concerning the role of characteristics in the small business-banking relationship. This study however failed to identify the distinct ethnic groups among the small business owners and the bankers. What is the effect of a Chinese/Malay bank manager on the relationship with Chinese/Malay small business owners? Further research is needed to answer these issues.

Fifth, there is little information available on the actual profitability arising from lending to small businesses. Although previous studies have revealed higher profit rates on small business loans, there is a need to undertake further research in developing countries for the purpose of validating these findings.

Finally, research is needed to identify and compare the success and failure of the small businesses that were given approvals, and those that failed to obtain bank loans. This would give further insight into the effectiveness of banks' lending decisions on small business propositions.

APPENDICES

Appendix A

Letter of Request

Chief Executive Officer
Bank.......................

Dear Dato,

I am writing to ask for your permission to conduct a research among some of the branch managers of your bank. I am currently an academic on the staff of Universiti Utara Malaysia, and I am now pursuing a PhD programme at the University of Glasgow, in Scotland. As part of the programme, I am carrying out research on the decision-making processes of Malaysian bank managers in granting loans and advances to their small business customers. My method of study will entail a personal interview with individual branch managers, and the scope covers the branch managers in the northern parts of Peninsula Malaysia. Your bank has been included in my research as it is known to be an established commercial bank with innovative banking products specifically designed for the small business sector.

As a former banker myself, I am fully aware of the banking operations and practices which are strictly subject to 'banking secrecy', whereby no information is to be revealed to the public. However, my research involves only certain behavioural aspects of the managers, and I will not be discussing the bank policies or any other matters that are deemed confidential. It is hoped that the outcome of this research will increase the understanding of a bank manager's lending decisions when dealing with small business customers. This should be of considerable benefit both to the small business sector, and also to the banking community.

I am planning to carry out the fieldwork next year from March to July, when I will be back in Malaysia. The branch managers will be selected randomly from the states of Penang, Kedah, Perlis, Kelantan and Terengganu. The interview may take about two hours, and the information obtained will be treated in the strictest confidence and will be used in such a way as to preserve complete anonymity. I also understand that bank managers have many demands on their time, but I really hope they will be able to spare time with me. I am therefore asking for your support and permission to approach the individual bank managers selected for this research. I am of course willing to abide by any conditions that you may need to impose.

I look forward to your help with this relevant piece of work.

Yours sincerely,

ROSLI MAHMOOD

Appendix B

Questionnaire

Let me introduce myself. I am currently pursuing a PhD programme at the University of Glasgow, in Scotland. As part of the programme, I am carrying out research on the decision-making process of Malaysian bank managers in granting loans and advances to small businesses. Your bank has been included in my research as it is known to be an established commercial bank with innovative banking products specifically designed for the small business sector. It is hoped that the outcome of this research will increase the understanding of a bank manager's lending decisions when dealing with small business customers. This should be of considerable benefit both to the small business sector and also to the banking community.

This questionnaire consists of THREE sections. The first section involves a simulation exercise. You are given a business plan for a new venture which requires a loan of RM200,000. I will be acting as an entrepreneur applying for the loan, and will be interviewed during the discussion. You will be asked to assess the application and the business plan in a realistic manner, and to give your judgement on whether to accept or reject it. To help in your decision, you are given a scoring scale of 0 to 10, where greater than 5 means you are willing to approve the loan, less than 5 means you are not willing to provide the loan, and a 5 means that you are putting your decision on hold. You must give reason(s) for your decision.

The second section of the questionnaire requires you to rate the relative importance of criteria used in the assessment of small business loan propositions on a five-point scale ranging from 'great importance (5)' to 'unimportance (1)'. You will be asked to elaborate on each criterion that you rated. Finally, in the third section, you are asked to provide general information about yourself and your bank branch.

The interview may take about two to three hours, and the information obtained will be treated in the STRICTEST CONFIDENCE and will be used in such a way as to preserve complete anonymity. This research will not touch on your bank policies and other matters that are deemed confidential. I hope that you will be able to spare time with me.

SECTION ONE

This section involves a simulation exercise where you are required to interview the researcher acting as a small business entrepreneur requesting a bank loan. A business plan for a new venture is proposed and presented for a loan of RM200,000. You are asked to assess this proposition in a realistic manner, and to give your judgement on whether to accept or reject the loan request. You must give reasons for your decision. There is a scale of 0 (zero) to 10 (ten) to assist in your decision, with greater than 5 (>5) being favourable (accept), and less than 5 (<5) being unfavourable (reject) for the loan.

To develop an understanding on a bank manager's lending decisions, you are also asked to give comments and suggestions on the proposed business plan.

Comments

....

....

....

....

....

....

Recommendations

....

....

....

....

....

Score (Please circle the appropriate number)

0 1 2 3 4 5 6 7 8 9 10

SECTION TWO

Part I

This section consists of a list of criteria generally used in assessing the small business loan applications. You are required to rate the relative importance of these criteria based on a FIVE point scale as shown below:

Great Importance	5
Importance	4
Moderate Importance	3
Slight Importance	2
Unimportance	1

Please circle the appropriate number according to the degree of importance.

1.	Size of loan relative to size of business	5	4	3	2	1
2.	Gearing	5	4	3	2	1
3.	Projected income	5	4	3	2	1
4.	Intended purpose of loan	5	4	3	2	1
5.	Liquidity ratios	5	4	3	2	1
6.	Availability of collateral	5	4	3	2	1
7.	Repayment of previous loans	5	4	3	2	1
8.	Loan activity at other banks	5	4	3	2	1
9.	Type of business activity	5	4	3	2	1
10.	Repayment schedule	5	4	3	2	1
11.	Length of time doing business with bank	5	4	3	2	1
12.	Trading experience	5	4	3	2	1
13.	Equity stake in business	5	4	3	2	1
14.	Net profit to sales	5	4	3	2	1
15.	CVs of client	5	4	3	2	1
16.	Trade creditors	5	4	3	2	1
17.	Trade debtors	5	4	3	2	1
18.	Government guarantee of loan	5	4	3	2	1
19.	Charge on assets	5	4	3	2	1
20.	Existing profitability	5	4	3	2	1

Part II

Can you elaborate on criteria you rated?

....

....

SECTION THREE

General information about yourself and your bank (Please tick or fill the appropriate column)

1. Your sex

...............Male
...............Female

2. Your age (in years)

...............25 – 29
...............30 – 35
...............36 – 40
...............41 – 45
...............46 – 50
...............Above 50

3. Your qualification

...............Non graduate
...............University graduate

4. Your banking experience

.... 5 – less than 10 years
...............10 – less than 15 years
...............15 – less than 20 years
...............20 and more years

5. Your experience in a managerial position in the bank

.... less than 5 years
.... 5 – less than 10 years
...............10 – less than 15 years
...............15 – less than 20 years
...............20 and more years

6. Number of bank employees in the branch

...............less than 15
...............15 – less than 25
...............25 – less than 40
...............40 – less than 60
...............60 – less than 80
...............80 and more

7. Your bank status

...............Tier I
...............Tier II

8. Types of small business loans/facilities offered

....
....
....
....

THANK YOU

Appendix C

Business Plan

This business plan is for a new venture in support of a loan application of RM200,000. The company has a paid-up capital of RM100,002, and it's principal activity is in project management and consultancy services.

The details of the company's project, management team, and the projected profit and loss, and cash-flow statements are given in the business plan.

1. BACKGROUND OF THE COMPANY

PERIBU Consultancy Sdn. Bhd. (PCSB) was incorporated on January 1, 1998 with an authorised capital of RM500,000. Its present paid-up capital stands at RM100,002. The company is principally involved in project management, consultancy and construction activities.

2. SHAREHOLDING

Shareholder	No. of Shares
Mr. XXX	50,001
Mr. YYY	50,001

3. DIRECTORSHIP

Mr. XXX	Executive Director
Mr. YYY	Project Director

(A Profile of the directors is given in the annexure)

4. MANAGEMENT

The management team is headed by Mr. XXX, and assisted by Mr. YYY. Mr. XXX had wide experience in project management consultancy as he is also one of the partners in M & N Associates, an engineering consultancy firm.

Mr. YYY had 18 years of experience in the electrical engineering field. He is the project director of the company, and is responsible for the implementation and supervision of the project.

5. INFORMATION ON THE PROJECT

PCSB has been awarded a five (5) year contract to provide for the building management services to Kedah Utara College (KUC), an established private institution in the northern part of Peninsula Malaysia, for its BBA twinning programme with Universiti Utara Malaysia (UUM).

The contract involves the conversion of 10 units of existing two (2) storey shophouses, located at the hub of Alor Setar town centre, into classrooms, computer lab, library and administration offices for KUC. The premises will form part of the KUC campus for its franchised BBA programme in collaboration with the Universiti Utara Malaysia (UUM).

The proprietor of these shophouses is the Kedah State Economic Development Corporation (KSEDC), who agrees to lease them to PERIBU Consultancy Sdn. Bhd. (PCSB) for a term of five (5) years. Under this lease agreement, PCSB will pay a monthly rental of RM12,000 (Twelve thousand ringgit only) to KSEDC.

These premises will then be subleased to Kedah Utara College (KUC) together with the equipment, fixtures and other fittings. The sublease agreement is also for a term of five (5) years. PCSB will provide for all building services such as electrical installation, air conditioning services, telephone installation, plumbing, cleaning and maintenance services for the agreement period. Under this sublease agreement, KUC agrees to pay PCSB a monthly rental of RM50,000 (Fifty thousand ringgit only).

6. PROJECT COSTS*

Renovation works	RM 83,579
Electrical works	55,922
Air-conditioning works	53,950
Computer lab	27,893
Telephone installation	10,420
Painting works	24,000
TOTAL COSTS	RM255,764

(*These costs are estimated figures quoted by a consultant to convert the shophouses into classrooms, computer lab, library and administration offices)

7. PROJECTED PROFIT AND LOSS ACCOUNT

(in Malaysian Ringgit)

	1998	1999	2000	2001	2002
INCOME	600,000	600,000	600,000	600,000	600,000
EXPENDITURE					
Rental	144,000	144,000	144,000	144,000	144,000
Salaries & wages	96,800	101,640	106,722	112,058	117,660
Office expenses	24,000	25,200	26,460	27,783	29,172
Miscellaneous	36,000	37,800	39,690	41,675	43,758
Cleaning and Maintenance services	120,000	120,000	120,000	120,000	120,000
Depreciation	10,000	10,000	10,000	10,000	10,000
Profit before interest	169,200	155,360	140,828	125,569	109,550
Interest charges	16,100	16,100	16,100	16,100	16,100
NET PROFIT BEFORE TAXES	143,100	139,260	124,728	109,469	93,450

8. PROJECTED CASH FLOW

(In Malaysian Ringgit)	1998	1999	2000	2001	2002
CASH INFLOW					
Capital	100,000				
Bank Loan	200,000				
Income	600,000	600,000	600,000	600,000	600,000
TOTAL	900,000	600,000	600,000	600,000	600,000
CASH OUTFLOW					
Rental payment	144,000	144,000	144,000	144,000	144,000
Salaries & Wages	96,800	101,640	106,722	112,058	117,660
Office expenses	24,000	25,200	26,460	27,783	29,172
Miscellaneous	36,000	37,800	39,690	41,675	43,758
Cleaning and Maintenance services	120,000	126,000	132,330	138,915	145,860
Vehicle (staff car)	50,000				
Loan repayment	56,088	56,088	56,088	56,088	56,088
TOTAL	782,652	490,728	505,290	520,519	536,538
NET CASH FLOW	117,348	109,272	94,710	79,481	63,462

9. ASSUMPTIONS IN THE PROJECTED PROFIT & LOSS AND CASH FLOWS

i. Monthly rental received from KUC is RM50,000, and remains unchanged for the next five years.

ii. Rental chargeable by KSEDC for the 10 unit shophouses is at RM12,000 as per agreement.

iii. Salaries and wages, office expenses, miscellaneous, cleaning and maintenance services are assumed to increase at 5.0 per cent per annum.

iv. Depreciation for staff car is on straight-line basis for five years.

v. BLR is at 12.2%, and interest charges are based on +2% over BLR. Calculation of yearly interest is assumed on straight-line basis.

ANNEXURE

Mr. XXX	
Date of Birth	1956
Place of Birth	Alor Setar, Kedah
Nationality	Malaysian
Qualifications	BSc. Engineering Brighton Polytechnic Sussex, United Kingdom MSc Engineering Northwestern University Evanston, Illinois, USA
Professional Membership	Institute of Engineers, Malaysia American Society of Civil Engineers
Professional Experience	I have been in the engineering services since 1978, first as an engineer with the government, and later as a senior engineer with a large consultancy firm, Stanwich Consultancy Sdn. Bhd. My responsibilities then include designing and supervising service systems, liasing with the government departments, preparing tender documents, assessing tender contract administration, and project management.
Position	Executive Director

Mr. YYY	
Date of Birth	1958
Place of Birth	Kuala Lumpur
Nationality	Malaysian
Qualification	BSc Electrical and Electronic Engineering University of Bath United Kingdom
Professional Membership	Institute of Engineers, Malaysia M'sian Institute of Management
Professional Experience	I had been in the government service as an assistant district engineer LLN, district manager LLN and an area construction engineer LLN. My responsibilities then include the designing, supervision, installation and commissioning of electrical networks for Peninsula Malaysia. I was also responsible for preparation of tender documents and evaluations.
Position	Project Director

GLOSSARY OF ABBREVIATIONS AND ACRONYMS

AA	Application for Accommodation
ASLS	Association Special Loan Scheme
BAFIA	Banking and Financial Institutions Act
BCIC	Bumiputera Commercial and Industrial Community
BLR	Base Lending Rate
BNM	Bank Negara Malaysia (Central Bank of Malaysia)
CAMPARI	Character, Ability, Margin, Purpose, Amount, Repayment, and Insurance
CEO	Chief Executive Officer
CGC	Credit Guarantee Corporation
EU	European Union
GDP	Gross Domestic Product
GGS	General Guarantee Scheme
HPTLS	Hawkers and Petty Traders Loan Scheme
ICA	Industrial Co-ordination Act
IMP	Industrial Master Plan
ITAF	Industrial Technical Assistance Fund
KSEDC	Kedah State Economic Development Corporation
LLN	Lembaga Letrik Negara (National Electricity Board)
MIDA	Malaysian Industrial Development Authority
MITI	Ministry of International Trade and Industry
NDP	New Development Policy

NEDO	National Economic Development Office
NEP	New Economic Policy
NERA	National Economic Research Associates
NPGS	New Principal Guarantee Scheme
NPLs	Non Performing Loans
NST	New Straits Times
OPP1	First Outline Perspective Plan
OPP2	Second Outline Perspective Plan
PGS	Principal Guarantee Scheme
RM	Ringgit Malaysia (Malaysian Currency)
SBA	Small Business Administration
SCPR	Social and Community Planning Research
SCRAP	Security, Creditworthiness, Repayment, Amount and term, and Purpose
SED	Small Enterprise Division
SLS	Special Loan Scheme
SMEs	Small and Medium-scale Enterprises
SMIs	Small and Medium-scale Industries
SMIDEC	Small and Medium Industries Development Corporation
SPSS	Statistical Package for the Social Sciences
SSEs	Small Scale Enterprises
SSIs	Small Scale Industries
UNIDO	United Nation Industrial Development Corporation
UUM	Universiti Utara Malaysia

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