

Lending to small business in Australia: a note

By Sudin Haron

Abstract

This paper investigates the perceptions of loan officers towards small businesses. It was designed to determine the problems faced by officers in dealing with small business borrowers and to determine the extent to which these problems influence the officer's decision-making process. This study, though confined to one major bank and involving 33 loan officers, gives insight not only to small businesses but to government agencies whose main objective is to provide assistance to small businesses. Problems that arose as a result of insufficient knowledge in business management appear to be the major difficulty faced by the loan officers when dealing with small business borrowers. This factor seems to have a significant impact on the officer's decision-making process. Metropolitan and big town officers appear to be more receptive to small business customers as compared to their counterparts in small towns and rural areas. The majority of the officers in small towns and rural areas believe that their small business customers will remain small indefinitely.

Introduction

Just like any other country in the world, the small business sector is one of the most important sectors in the Australian economy. While communities enjoy the benefit of their existence, the owners of these businesses face a number of hurdles and problems in trying to make their businesses survive and prosper. One of the problems faced by small business owners is difficulty in obtaining credit from banks (Business & Consumer Affairs, 1990). They sometimes claim that banks are more accommodating to corporate businesses because

this relationship would generate more income and less risk (Turnbull and Gibbs, 1987).

There are many studies which indicate the close relationship between financial management and the success or failure of small businesses (for an excellent survey of this literature, see Berryman, 1993). Connell (1993) believed that the next few years are important periods for small businesses seeking finance. The issues of insufficient finance and difficulties in obtaining financing from the banks will remain as long as there is an information gap between the banks and small business owners. Small business owners are not supplied with information on the banks' lending policies and criteria, whereas bankers are ignorant about the hidden opportunities provided by the small business sector. Helping small business means building the local and national economy, which in turn benefits the banks as loans and deposits grow.

Among bankers, Wright (1989) gave an opinion as to why small businesses failed to get financing from the banks. Basically the reasons fall into one or more of these categories:

- The security available from the applicant is considered by the lender inadequate to support the borrowing.
- The term required for repayment of the finance is too long.
- The business lacks of a sound track record or has a poor record and, allied with the security deficiency, it is not possible for the lender to judge its prospects of success.

The above reasons, however, are not elaborative enough and are given by a person who is at the

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higher level of a bank's hierarchy. Banking literature outlines the factors used by bankers in assessing credit worthiness of a potential borrower. These factors are commonly known as the five Cs of credit: character, capacity, capital, conditions and collateral. 'Character' involves attitude, level of knowledge in all aspects of business, and the way of thinking of the applicant. 'Capacity' relates to the ability to pay back the loan either from income generated by the business or from other sources. 'Condition' deals with the environment in which the business operates. 'Capital' pertains to the amount of resources owned by the applicant prior to engaging in intended business activities, and 'collateral' refers to the properties or assets that the applicant offers to the bank as security in case of default.

The purpose of this study is to highlight the problems faced by Australian bank officers which relate to the above credit factors when dealing with small business loans. The problem areas used in this study are similar to the problem areas identified by Haron and Shanmugam (1994). Although the problem areas used by this questionnaire are based on the Malaysian environment, it would be interesting to know whether bankers in Australia are also facing similar problems to their Malaysian counterparts. The definition of small business used in this study is based on the definition of the Beddall Committee, that is, businesses which are independently owned and managed, closely controlled by owner/managers who also contribute most, if not all, of the operating

capital with the principal decision-making functions resting with the owner/managers.

Only one big bank participated in this study and samples were selected from branches within the state of New South Wales. A total of 100 questionnaires were sent via branch managers to officers who are responsible for small business loans. The selection of branches was based on systematic random sampling. The book containing addresses of all branches of the participating bank was used as a sampling frame and branches occupying every fifth spot in the address list were selected as samples. Thirty-three questionnaires were returned by loan officers. Since this was only an exploratory study, no attempt was made to increase the number of responses.

The questionnaire contained three sections. The first section gathered information about the respondents' personal backgrounds. The characteristics of the respondents are presented in Table 1. With respect to age, 63.7 per cent of the loan officers were older than 35 years of age. In terms of qualifications, 27 officers or 81.8 per cent of respondents do not possess any degree or professional qualification, while those who have a diploma or degree are mostly from the disciplines of business, accounting and economics. With regard to banking experience, 75.8 per cent of the loan officers have been with the bank for more than 15 years but the majority of them, that is 57.6 per cent, have less than 10 years experience in credit management.

TABLE 1: Characteristics of respondents

	Number *	Per cent
Age:		
Younger than 29 years	4	12.1
30 - 34	8	24.2
35 - 39	12	36.4
40 years and older	9	27.3
	33	100.0
Highest academic qualification:		
High school or diploma	27	81.8
Degree or professional	6	18.2
	33	100.0
Discipline:		
Business, accounting, or economics	18	78.3
Arts, engineering, or science	5	21.7
	23	100.0
Length of service with the bank:		
Less than 5 years	2	6.1
5 - 9	2	6.1
10 - 14	4	12.1
15 - 19	13	39.4
20 years or more	12	36.4
	33	100.0
Involvement in credit work:		
Less than 5 years	3	9.1
5 - 9	16	48.5
10 - 14	7	21.2
15 - 19	5	15.2
20 years or more	2	6.1
	33	100.0
Location of branch:		
Metropolitan or big town	22	66.7
Small town or rural area	11	33.3
	33	100.0

* Varying in total due to the missing responses.

The second section of the questionnaire contained two questions. The first question asked respondent's about their perception of the future of their small business clients and the second question was designed to identify their preferences in applying the five credit factors of loan appraisal (character, capacity, capital, condition and collateral). The final part of the questionnaire was designed to generate data concerning the problems faced by the bank officers when dealing with loan applications made by small business owners. The officers were asked to denote the frequency of occurrence of the problems on a five-point scale ranging from 'never occurred' to 'occurred all the time'. The respondents were also asked to indicate the degree of importance of various problems in influencing their recommendation for approval of the loan application. Beside the opinions of total respondents (all officers), this study also highlights the opinions of two separate groups, that is, officers who serve small business customers in metropolitan areas and big towns and those in small towns and rural areas.

Findings

The list of problems and their frequency of occurrence is presented in Table 2. As shown, the five most common problems faced by the loan officers when dealing with small business customers were the customers' inability to prepare a proper business plan, limited sources of income for the loan's repayment, incomplete information on the loan proposal given to the bank, the applicant's lack of knowledge in working capital management, and finally the applicant's lack of knowledge in marketing. The five least common problems were improper reasons for entering business, maintaining no account with the branch or bank, entering into unprofitable business, failure to impress officer during the first meeting, and lack of confidence in applying for the loan.

TABLE 2: Frequency of occurrence of major problems faced by officers when dealing with small business loan applications (Mean*)

	All	M & BT	ST & R
1. No proper business plan.	4.09	4.19	3.91
2. Total dependence on business income as source of loan repayment. No other income to support the application.	3.94	3.90	4.00
3. Insufficient information in the loan proposal given to the bank.	3.72	3.81	3.55
4. Lack of knowledge in working capital management.	3.63	3.67	3.55
5. Lack of knowledge in marketing.	3.63	3.62	3.64
6. Business is a one-man show.	3.62	3.57	3.73
7. Own contribution relatively small compared to loan requested.	3.56	3.52	3.64
8. Lack of knowledge in accounting	3.47	3.38	3.64
9. Great urgency for loan.	3.47	3.71	3.00
10. Entering into competitive business.	3.41	3.62	3.00
11. Unable to explain financial problem professionally.	3.34	3.33	3.36
12. Lack of knowledge about banking facilities available to them.	3.28	3.24	3.36
13. Total dependence on officer to determine the amount required and other terms.	3.22	3.19	3.27
14. Lack of knowledge in overall business management.	3.19	3.24	3.09
15. Unclear about where their business is going.	3.13	3.19	3.00
16. Unable to provide collateral as requested to support the loan application.	3.09	3.10	3.09
17. Unable to determine actual amount of financing or loan required for the business.	3.06	3.10	3.00
18. Newcomer to the venture.	3.00	3.10	2.82
19. Having an attitude that he/she is the only one who knows all the aspects of his/her business.	2.87	2.90	2.82
20. Unable to decide the appropriate banking facilities for their business.	2.81	2.86	2.73
21. Constantly disturbing officer by phone or other means to know the fate of their loan application.	2.78	2.86	2.64
22. Lack of confidence and always relying on others to help them in the loan application.	2.78	2.76	2.82
23. Fail to impress officer with appearance or personality during the first interview.	2.59	2.67	2.45
24. Entering into unprofitable business.	2.59	2.67	2.45
25. Maintaining no account with the branch (bank).	2.50	2.52	2.45
26. Entering into business of political reason or reason other than own interest.	1.72	1.71	1.73

*1: Never occurred 2: Not often 3: Sometimes 4: Often 5: Occurred all the time

Notes: M & BT = Metropolitan or big town

ST & R = Small town or rural

There are some disparities of opinion between metropolitan and small town officers. The first major problem encountered by the metropolitan officers was inability of small business customers to prepare a proper business plan, whereas this problem is considered second by the small town and rural officers. For the small town and rural officers, their first problem was confronting small business customers who had limited sources of income for the loan's repayment and this problem was considered second by the metropolitan and big town officers. To the metropolitan and big town officers, the other three most encountered problems were incomplete information on the loan application, great urgency for the loan, and the applicant's lack of knowledge in working capital management. In contrast, for the small town and rural officers, the other three most encountered problems were the owners managing their business by themselves, insufficient personal financial contribution as compared to the loan requested, and the applicant's lack of knowledge in marketing. There are not many differences among these two groups of officers on the least encountered problems.

Rank	Metropolitan	Small Town	Rural
1	Inability of small business customers to prepare a proper business plan	Confronting small business customers who had limited sources of income for the loan's repayment	Confronting small business customers who had limited sources of income for the loan's repayment
2	Confronting small business customers who had limited sources of income for the loan's repayment	Inability of small business customers to prepare a proper business plan	Inability of small business customers to prepare a proper business plan
3	Incomplete information on the loan application	Great urgency for the loan	Great urgency for the loan
4	Great urgency for the loan	Incomplete information on the loan application	Incomplete information on the loan application
5	Applicant's lack of knowledge in working capital management	Owners managing their business by themselves	Owners managing their business by themselves
6	Owners managing their business by themselves	Applicant's lack of knowledge in marketing	Applicant's lack of knowledge in marketing
7	Applicant's lack of knowledge in marketing	Insufficient personal financial contribution as compared to the loan requested	Insufficient personal financial contribution as compared to the loan requested
8	Insufficient personal financial contribution as compared to the loan requested	Applicant's lack of knowledge in working capital management	Applicant's lack of knowledge in working capital management
9	Applicant's lack of knowledge in working capital management	Least encountered problems	Least encountered problems
10	Least encountered problems	Least encountered problems	Least encountered problems

Table 3 illustrates the level of importance associated with the problems that tend to influence the final decision of loan approval. Unprofitable business proposals submitted by small business customers was the variable which loan officers perceived to be the most important in adversely affecting their decision-making process. The second most important variable was the inability of applicant to provide collateral as requested, followed by incomplete information on the loan application, the applicant's lack of knowledge in overall business management, and the direction of the business. Variables such as maintaining no account with the branch or bank, lack of knowledge about banking facilities for small businesses, and business being managed by the owners themselves were not important to the loan officers. There are many similarities of opinions for both groups of officers on the effect of these variables in their decision making process.

TABLE 3: Importance of problems in influencing final decision on loan (Mean*)

	All	M & BT	ST & R
1. Entering into unprofitable business.	4.88	4.82	5.00
2. Unable to provide collateral as requested to support the loan application.	4.64	4.64	4.64
3. Insufficient information in the loan proposal given to the bank.	4.55	4.68	4.27
4. Lack of knowledge in overall business management.	4.45	4.36	4.64
5. Unclear about where their business is going.	4.36	4.41	4.27
6. No proper business plan.	4.30	4.18	4.55
7. Entering into business of political reason or reason other than own interest.	4.18	4.27	4.00
8. Unable to determine actual amount of financing or loan required for the business.	4.09	4.14	4.00
9. Newcomer to the venture.	3.97	3.95	4.00
10. Entering into competitive business.	3.85	3.77	4.00
11. Own contribution relatively small compared to loan requested.	3.76	3.59	4.09
12. Lack of knowledge in working capital management.	3.76	3.64	4.00
13. Lack of knowledge in marketing.	3.76	3.68	3.91
14. Total dependence on officer to determine the amount required and other terms.	3.73	3.64	3.91
15. Lack of confidence and always relying on others to help them in the loan application.	3.64	3.64	3.64
16. Unable to explain financial problem professionally.	3.61	3.64	3.55
17. Total dependence on business income as source of loan repayment. No other income to support the application.	3.55	3.68	3.27
18. Fail to impress officer with appearance or personality during the first interview.	3.52	3.41	3.73
19. Having an attitude that he/she is the only one who knows all the aspects of his/her business.	3.48	3.36	3.73
20. Great urgency for loan.	3.42	3.18	3.91
21. Lack of knowledge in accounting	3.12	3.00	3.36
22. Unable to decide the appropriate banking facilities for their business.	3.06	2.91	3.36
23. Business is a one-man show.	2.91	2.82	3.09
24. Constantly disturbing officer by phone or other means to know the fate of their loan application.	2.85	2.82	2.91
25. Lack of knowledge about banking facilities available to them.	2.61	2.45	2.91
26. Maintaining no account with the branch (bank).	2.52	2.55	2.45

*1: Not important at all 2: Not important 3: Slightly important 4: Important 5: Very important

Notes: M & BT = Metropolitan or big town

ST & R = Small town or rural

TABLE 4: Credit factors in order of importance (in percentage)

	1	2	3	4	5	Total	Mean*
Character	16.1	19.4	32.3	32.3	-	100.0	2.806
Capacity	74.2	22.6	3.2	-	-	100.0	1.290
Condition	-	-	6.7	23.3	70.0	100.0	4.633
Capital	9.7	29.0	29.0	22.6	9.7	100.0	2.935
Collateral	3.2	29.0	29.0	16.1	22.6	100.0	3.258

* 1 = Very important 5 = least important

TABLE 5: Officers perception of future prospects of their small business customers to become commercial or corporate customers (in percentage)

	Yes	Not sure	No	Total	Mean*
All respondents	36.4	21.2	42.4	100.0	2.061
Metro & big towns	40.9	31.8	27.3	100.0	1.864
Small & rural areas	27.3	-	72.7	100.0	2.455

1 = Yes 2 = Not sure 3 = No

The officers' opinions on the five credit factors are highlighted in Table 4. When lending to small business, bank officers are said to perceive capacity as the most important factor in making any loan decision, followed by character, capital, collateral, and condition.

The years of experience in credit work, location of the branch, qualification, discipline of qualification, and age of the officer are considered as the potential variables that influence the officer's perceptions towards small business borrowers. The chi-square test of independence was used to measure the association between all these variables and the

respondents' perceptions on the future of their small business customers.

With the exception of location, where the Pearson chi-square value was 7.45 and significant at 0.05 per cent, other results were unusable due to the insufficient number of observations in the cell. Since the result indicated that location had an impact on officers' perceptions towards small business, the breakdown of these perceptions is highlighted in Table 5.

Table 5 indicates that a large number of metropolitan and big town officers (40.9 per cent) believed that their small business customers were able to become commercial or

corporate customers, whereas the majority of loan officers (72.7 per cent) who served in small towns or rural areas believed otherwise. The difference in attitude between these two categories of officers is influenced by several factors. In the case of small towns and rural areas, the trading area for a particular type of business and future expansion are easily identifiable, thus the loan decision is made on definite information. Some small town or rural area customers, due to the limited number of banks or other intrinsic reasons, are likely to remain with a particular bank. Therefore, loan officers in small towns tend to know not only the business background but also the personal life of the potential borrower, more so than their metropolitan colleagues. For metropolitan officers, broader opportunities and wider trading areas could be reasons for them believing that their small business customers are potentially viable and will someday become commercial or corporate customers.

Concluding remarks

This study, though exploratory and involving only 33 loan officers from one of the major banks in Australia, provides two important findings for small business owners. First, this study establishes that problems related to the character factor appear to be the major difficulty faced by the loan officers when dealing with small business borrowers. Among the most common problems are the lack of a proper business plan, limited sources of income, incomplete information on the loan proposal, lack of knowledge in working capital management, lack of knowledge in marketing, the business being a one-person show, insufficient personal financial contribution as compared to the loan amount requested, lack of knowledge in accounting, and great urgency for the loan.

Second, by knowing the importance of each factor in influencing a loan officer's decision making process, remedial action by small business can be taken prior to approaching loan

officers for financing, thereby increasing the possibility of loan acceptance. Clearly, loan officers perceived factors that relate to capacity as the most important factor when making the loan decision. Although collateral is ranked fourth behind capacity, character and capital, nevertheless small business borrowers often fail to provide sufficient collateral when requested by loan officers. Factors that reflect the borrower's business knowledge, such as incomplete information given to the bank, lack of knowledge in overall business management, vagueness about the future of their business, lack of a proper business plan, and the inability of applicants to determine the actual loan required for their businesses are also important factors for the loan officers in their loan appraisal process.

Small business owners have expressed a willingness to enhance their knowledge and skill in managing their business. The findings of a recent study, for example, indicated the desire of small business owners to increase their knowledge and skill especially in the area of preparing a business plan, managing finance, record keeping and costing (Peacock, 1995). To small business educators, positive attitudes towards enhancing skill and knowledge shown by small business owners should be regarded as an opportunity and an obligation. Moreover, the perceptions of loan officers towards small businesses elaborated in this paper suggest that education in areas like business planning, accounting and marketing, and strategic management are a real necessity in the small business sector.

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