Difficulties in Securing Funding from Banks: Success Factors for Small and Medium Enterprises (SMEs)

Z. Zairani
Department of Islamic Banking and Finance, Islamic Business School, Universiti Utara Malaysia, Malaysia
Email: zairani@uum.edu.my

Z. A. Zaimah
Department of Accounting and Taxation, School of Accounting, Universiti Utara Malaysia, Malaysia
Email: zaimah@uum.edu.my

***Abstract*—Previous literature indicates that small and medium enterprises (SMEs) experience problems securing funds from banks to development their businesses. Although SMEs are the backbone of every country and play a significant role in economic development, banks still appear reluctant to approve loans, especially to micro businesses. This situation has resulted in some SMEs turning to illegal money lenders/loan sharks or "Ah Long", because this is the fastest and easiest way of obtaining finance. Nevertheless, banks must consider several factors before they can approve a loan to SMEs because the credit risk associated with such a loan is high. The aims of this paper are to (i) explain the problems that banks face with loan applications by SMEs and (ii) examine the factors involved in obtaining loans from banks. The study employed a qualitative research approach, with officials from five banks in Malaysia interviewed about problems they faced with loan applications from SMEs. The paper attempts to contribute theoretically and practically to the literature on SMEs and provide information for SMEs on the factors that must be considered when dealing with banks.**

***Index Terms*—bank loans, funding, micro businesses, small and medium enterprises (SMEs)**

I. Introduction

Small and medium enterprises (SMEs) play a significant role in economic development and are considered the backbone of industrial development. The contribution of SMEs to a nation's economy can be seen in a number of ways, such as employment opportunities and economic output. The objectives of encouraging SMEs in developing countries are to combat unemployment, increase the rate of growth of real per capita income, balance income distribution and improve economic stability [1]. Almost all countries, including Malaysia, acknowledge the significant role that SMEs play in their economic development. In Malaysia, SMEs have contributed about 31 percent of the country's gross domestic product (GDP), they employ 56 percent of the workforce and account for 19 percent of total exports. Moreover, SMEs account for 99 percent of total businesses in Malaysia. In view of the importance of SMEs to the economy, the Malaysian government has taken various steps to promote their growth. For example, the SME Master Plan 2011 to 2020 has been designed to align the roles of this sector and the New Economic Model (NEM). However, despite the acknowledged importance of SMEs, they continue to face difficulties securing funding. SMEs in Malaysia often face problem in obtaining funds from financial institutions and the government [2]. Usually, the interest rate charged by financial institutions on loans to SMEs is high. In addition, the financial institutions frequently require collateral before they will approve a loan. Although SMEs, specifically micro businesses, may be viable and have a promising future, arranging such collateral may be problematic. This situation has resulted in some SMEs turning to illegal money lenders/loan sharks or "Ah Long"[1], because this is the fastest and easiest way of obtaining finance. Ah Long requires no collateral or proper documentation, but those who fail to pay on time face the threat of violence. The objectives of this paper are to (i) explain the problems that banks face with loan applications by SMEs and (ii) examine the factors involved in obtaining loans from banks.

II. Problems that Banks Face with Loan Applications by SMEs

The financing of SMEs has attracted much attention in recent years, driven in part by the fact that SMEs account for the majority of firms in most countries around the world and account for a significant share of employment [16]. Furthermore, most large companies usually start out as

Manuscript received July 28, 2013; revised September 30, 2013.

[1] Ah Long is a term for illegal loan sharks in Malaysia and Singapore. They lend money to people who are unable to obtain loans from banks or other legal sources. They charge a very high interest rate and frequently threaten violence (and administer it) if the loan is not repaid on time.

doi: 10.12720/joams.1.4.354-357

small enterprises, so the ability of SMEs to develop and invest becomes crucial to any economy wishing to prosper. For SMEs to remain viable and grow, it is crucial for them to have access to, and be able to obtain, financial support. Lack of access to financing is a key obstacle to a business's growth, especially SMEs [3]. [4] in their study asserted that small and new businesses face problems in securing finance compared with larger, established companies. [3] highlighted three factors that make financial institutions uninterested in involvement with SMEs: (i) financing SMEs is difficult because they are opaque[2]; (ii) SMEs are more likely to be informal compared with large firms, something that compounds their opaqueness and poses additional obstacles and risks to SME lending; and (iii) banks cannot lend to SMEs if they are unable to provide reliable accounts detailing their financial activity. [5] also highlighted the importance of financial accounting, stating that the principal factor that banks take into consideration when conducting credit analysis is the company's financial statement. An audited financial statement (e.g., chairman's and auditor's reports) is the most important type of qualitative information, and that a balance sheet is the most important type of quantitative information [5]. [6] stated that because SMEs usually do not have current audited financial statements it is difficult for them to ascertain their capability/ability to repay a loan, and at the same time to build up a good reputation and relationship with financial institutions. According to [7], financial institutions use almost the same method, qualitative and quantitative information, to evaluate both large and small companies.

The purpose of the loan is also an important factor financial institutions take into consideration when deciding whether to approve a loan [5]. The purpose refers to the type of business the SME is involved in or to the nature of the business the SME wishes to set up. Banks will consider businesses that are viable, able to generate income in the long term and appear likely to be successful in the market. [8] previously discussed the importance that banks place on collateral when approving loans for SMEs, and suggested that the bank requires collateral to offset the risk of bad debts. [9] and [10] concluded that collateral minimises moral hazard problems. According to [7], other factors that banks consider in a loan application from SME are the company's management structure and efficiency, profit potentiality, market strength, performance and geographical location.

[11] Elucidated several problems faced by SMEs in obtaining loans from banks: (i) they cannot provide an appropriate guarantor, or the collateral is not sufficient given the amount they wish to borrow; (ii) they do not have sufficient experience in the areas of management, planning and business operation, and their future business prospects appear unconvincing; (ii) they lack adequate and accurate information on development programs for SMEs offered by government agencies and financial institutions; and (iv) they are confused by the types of loans or programs best suited to their need as some of the programs/loans overlap. [12] concluded that SMEs lack accurate information on the types of loans available. They reported that SMEs depend on informal information sources (hearsay) regarding available loans or programs, rather than on official information from banks or government agencies. The study asserted that the lack of knowledge means that available grants/funds are not fully utilised by SMEs.

III. Methodology

This exploratory study employed a qualitative research approach, a library search and interviews. Officials from five banks in Malaysia were asked about the problems they faced with loan applications from SMEs.

The main purpose of this study was to prove the existence of the subject under discussion that is the problems that banks face with loan applications by SMEs [12]. Although the data collection was based on a semi-structured questionnaire, the respondents had the freedom to raise issues not addressed by the questions, providing they fell within the scope of the research. The interviews were conducted with officials in charge of SMEs in their respective banks, and used to gauge the problems involved with loan applications.

After conducting the interviews, the researcher believed that the information obtained was sufficient to achieve the research objectives. The use of a criterion of 'satisfactory results' is consistent with [13], who claimed that when consistency in the pattern of problems faced by the respondents is achieved, the number of respondents is deemed sufficient to fulfil the desired results (satisfactory results).

IV. Results and Discussion

We have divided this section into two parts: (i) factors associated with obtaining loans from banks and (ii) discussion of the results.

A. Factors Associated with Obtaining Loans from Banks

Five banks were selected for the purpose of this study, although their identities will not be revealed as this information is associated with data confidentiality. We instead identified the five banks as Banks A, B, C, D and E. The results below indicate the nine factors identified by these banks as criteria associated with obtaining loans from them.

- SMEs with a good business record
- Viable industries/businesses
- Good and continuous relationships with banks
- SMEs that have experience with the businesses they are involved in (i.e., banks need to see how long a given business has been established)
- Financial statement with convincing cash flow
- Collateral
- Convincing project paper explaining the SMEs' businesses and the direction of those particular businesses

[2] Opaqueness means that it is difficult to know whether firms have the capacity to pay (have viable projects) or they have a willingness to pay (due to moral hazard).

- SMEs that possess all documentation required by banks (such as business registration)
- SMEs' commitment towards their existing loans/liabilities are convincing

Table I details the factors identified by each bank for obtaining a loan with them

TABLE I. FACTORS FOR OBTAINING LOAN

Factors	Bank A	Bank B	Bank C	Bank D	Bank E
i	√	√	√	√	√
ii.	√	√	√	√	√
iii	-	√	√	-	√
iv	-	-	-	√	√
v	√	√	√	√	√
vi	√	√	√	√	√
vii	√	√	√	-	-
viii	√	√	√	√	√
ix	√	√	√	√	√

B. *Discussion of the Results*

[5] pointed out that the principal factor banks take into consideration when performing credit analysis is the company's financial statement. Analysis of the financial statement will provide information about the capability of the borrower to pay back a loan and the level of risk exposure to the banks [14]. The data gleaned from the interviews supported this finding from the literature. The interviews with the bankers demonstrated that without a 'proper' financial statement it is unlikely that the banks will approve a loan, as SMEs cannot convince the bank of their capability to pay it back. However, some of the bankers explained that banks are less rigid with micro SMEs, as they do not have consistently audited financial statements. In this case, banks need to see only the business records or any evidence of cash flow, such as invoices, bills and current account/savings account statements. At the same time, the system employed by banks in Malaysia, including the Credit Control Record Information System (CCRIS), will show the exposure of the borrower's commitment to other loans or liabilities in Malaysia.

Collateral is another vital factor considered by banks when deciding whether to approve a loan. All interviewees said that although it is not stated in writing, they will consider the loan if the borrowers have collateral or a qualified guarantor. This finding is consistent with the study conducted by [8], which found that collateral is the principal factor for financial institutions in approving a loan. Although they realise that SMEs play a significant role in the economy, and that difficulties in obtaining loans could be obstacles to their business's growth, the banks require collateral to reduce moral hazard problems [9] and [15].

A study by [5] claimed that a good relationship between bank and borrower provides an advantage, as if they know each other well then collateral will no longer be a requirement. However, our findings went against this study. All interviewees stated that a good relationship would not lessen the requirement for collateral, specifically for micro SMEs. To approve a loan, banks require SMEs to have collateral and a guarantor. However, on the part of the government there are some positive efforts in this regard, with the availability of Credit Guarantee Corporations (CGC), through which the government guarantees loan applications by SMEs who are regarded as high-risk borrowers. However, CGC charges extra interest rate on top of that charged by the bank, which could prove burdensome for some SMEs.

Banks also consider the type of business in which the borrower is involved. This finding is consistent with [3], who reported that the purpose of the loan is an additional important factor financial institutions take into consideration when deciding whether to approve a loan. The type of business shows the marketability and competitiveness of that particular SME.

Above all, [16] concluded that SMEs lack accurate information on the types of loans available. They reported that SMEs depend on informal information sources (hearsay) regarding available loans or programs, rather than on official information from banks or government agencies. When asked about this issue, two of the bankers admitted that the workshops they conducted were attended by those that have good relationships with them and through some association, such as Malays Business Council. Therefore, micro SMEs may not have access to this type of workshop. It is possible that they are not involved with this association and have less exposure to and knowledge about the facilities/workshops.

V. CONCLUSION AND SUGGESTIONS

The study found that to minimise the credit risk, banks require SMEs to present certain documents before they can offer a loan. Although loans given to customers is one of their sources of income, as financial intermediary banks have a huge responsibility to their depositors and shareholders. Therefore, they must consider many factors in their credit analysis before approving certain loans. The study also identifies the success factors of SMEs in obtaining loans in Malaysia. Having identified these, we now present some suggestions to improve the financing system used by banks or financial institutions in dealing with SMEs.

First, given the importance of SMEs to the growth of GDP and employment opportunities in Malaysia, banks and financial institutions must consider their roles in facilitating industry. The banks should play their role in educating SMEs on the loans or special funds provided by government, and channelled through them, which are available to SMEs. If SMEs continue to have problems obtaining accurate information, it will prevent them from getting the most benefit out of the opportunities. It is hoped that workshops offered by banks or financial institutions are properly targeted to SMEs.

Banks should also offer free consultancy as part of their CSR (Corporate Social Responsibility). This can be done through their centre or branches to guide SMEs, especially micro businesses, on the documentation required for approving a loan. In addition, SMEs should be guided by expertise, especially experts from banks, to help establish viable and sustainable businesses. It is hoped that SMEs could benefit from this service, especially if the banks could engage more experts in different areas such as marketing, IT, financial planning and others.

Finally, SMEs are advised to take the opportunity to enhance their knowledge through the establishment of peer groups, which could liaise with the banks or government agencies to increase knowledge of the system and keep them updated with all relevant information.

REFERENCES

[1] M. K. Hashim, "A review of the role of SMEs in the manufacturing sector in Malaysia," *Malaysian Management Review*, pp. 40-49, June 1999.

[2] A. S. Saleh and N. O. Ndubisi, "An evaluation of SME development in Malaysia," *International Review of Business Research Papers*, vol. 2, no. 1, pp. 1-14, August, 2006.

[3] A. D. L. Torre, M. S. M. Peria, and S. L Schmukle, "Bank involvement with SMEs: Beyond relationship lending," *Journal of Banking and Finance*, vol. 34, pp. 2280-2293, February, 2010.

[4] D. E. Terpstra and P. D. Olson, "Entrepreneurial start-up and growth: A classification of problems," *Entrepreneurship Theory and Practice*, vol. 17, no. 3, pp. 5-15, Spring, 1993.

[5] A. Berry, S. Faulkner, and R. Jarvis, *Bank Lending: Beyond the Theory*, London: Chapman and Hall, 1993.

[6] A. N. Berger and G. F. Udell, "The economics of small business finance: The role of private equity and debt markets in the finance growth cycle," *Journal of Banking and Finance*, vol. 22, no. 6-8, pp. 613-673, 1998.

[7] W. Junjie, "An empirical evidence of small business financing in China," *Management Research News*, vol. 31, no. 12, pp. 959–975, 2008.

[8] B. A. Krasniqi, "Are small firms really credit constrained? Empirical evidence from Kosovo," *International Entrepreneur Management Journal*, vol. 6, no. 4, pp. 459–479, December, 2010.

[9] H. Bester, "The role of collateral in a model of debt renegotiation," *Journal of Money, Credit and Banking*, vol. 26, pp. 72-86, February, 1994.

[10] A. W. A. Boot, A. V. Thakor, and G. F. Udell, "Secured lending and default risk: Equilibrium analysis, policy implications and empirical results," *Economic Journal*, vol. 101, pp. 458-72, May, 1991.

[11] A. Mohd Asri, *Industri kecil di Malaysia, pembangunan dan masa depan*, Kuala Lumpur: Dewan Bahasa dan Pustaka, 1997.

[12] C. Forza, "Survey research in operations management: A process based perspective," *International Journal of Operations & Production Management*, vol. 222, no. 2, pp. 152–195, 2002.

[13] D. Aeker, V. Kumar, and G. Day, *Marketing Research*, New York, NY: Wiley, 1995.

[14] P. S. Rose, *Commercial Banking Management*, Singapore: Irwin McGraw-Hill International Editions, 1999.

[15] A. W. A. Boot and A. V. Thakor, "Moral hazard and secured lending in an infinitely repeated credit market game," *International Economic Review*, vol. 35, pp. 899-920, November, 1994.

[16] M. N. Hakimin, Y. Mohd Rafi, and I. Mohamed Dahlan, "Business advisory: A study on selected micro-sized SMEs in Kelantan, Malaysia," *International Journal of Marketing Studies*, vol. 2, no. 2, pp. 245-257, 2010.

Zairani Zainol is a senior lecturer of the Islamic Business School, College of Business, Universiti Utara Malaysia (UUM COB). She was awarded a PhD in Islamic Banking from Edinburgh University, United Kingdom in 2007. Her area of interest is Islamic banking, Islamic finance, Islamic financing and Small and Medium Enterprise (SME). She has been in service for more than 15 years in Universiti Utara Malaysia

Zaimah Zainol Ariffin is a senior lecturer of the School of Accountancy, College of Business, Universiti Utara Malaysia (UUM COB). She was awarded a PhD in Accounting and Finance from University of Wales, Bangor, United Kingdom in 2007. Her area of interest is Corporate Taxation, Individual Taxation, Tax Avoidance, Managerial Ownership and Small and Medium Enterprise (SME). She has been in service for more than 18 years in Universiti Utara Malaysia