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Cookie Cutter vs. Character Lending Approach : SMEs' Lending by Public and Private Sector Banks

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Abstract

The credit process represents a critical bank function. It has to ensure that credit is granted to customers who are capable as well as willing to repay the loan and interest, and denied to those who are not. Banks can follow either a cookie cutter approach where strict and standardised quantitative criteria are used and more reliance is made upon collateral/ security and personal guarantees. Second way-out is following character lending approach where banks favour qualitative criteria based upon applicants' earlier credit history / track record as well as their interactions with the loan officers. This paper is an attempt to compare public and private sector banks with respect to their approach as well as decision making criteria while extending credit to SMEs.

Keywords : SMEs, Banks, Attitude, Decision Making Criteria

INTRODUCTION

Small and medium enterprises occupy a position of strategic importance in economies of all developing countries of the world and India is certainly not an exception. These have emerged as a dynamic and vibrant sector in Indian economy. They have got twin roles to play. Besides playing an economic role for country's economic development, small and medium enterprises also play social and political role in employment generation, increasing standard of living and maintaining a balanced regional development (Mittal and Batra, 2004). Micro, small and medium enterprises are though individually small, but collectively they have emerged as a dominant player in Indian economy. They contribute 8% to country's

GDP, 45% to total industrial production and 40% to the exports of the country. This coupled with high labour to capital ratio, high growth and high dispersion makes them crucial for achieving the objective of inclusive growth (Economic Survey, 2010-11). They are estimated to employ about 59 million persons in over 26 million units throughout the country. Further, this sector has registered a higher growth rate i.e. 13% in 2007-08 than the rest of industrial sector (8%) (Annual report 2009-10, Ministry of MSME). As per MSMED Act, 2006, investment limits of plant and machinery in case of manufacturing enterprises and of equipment in case of service enterprises are as follows :-

Classification	Manufacturing enterprises	Service enterprises
Micro	Up to Rs. 25 lakh	Up to Rs 10 lakh
Small	25 lakh to 5 crore	10 lakh to 2 crore
Medium	5 crore to 10 crore	2 crore to 5 crore

Micro, small and medium enterprises (MSMEs) look forward to banks for their credit needs as commercial banks are the primary source of finance for them (Cole et al., 1996; Petersen and Rajan, 1994; Berger and Udell, 2002; Ghosh, 2007; Ruis et al, 2009). Financing to Micro, small and medium enterprises comes under the ambit of priority sector lending. Although there is no specified sub-target for financing to MSMEs for public and private sector banks, but banks have to extend 60% of the total credit, extended to MSMEs, to micro enterprises. The credit process represents a critical bank function. It has to ensure that credit is granted to customers who are capable as well as willing to repay the loan and interest, and denied to those who are not (Bruns and Fletcher, 2008). As a result, it becomes essential for banks to develop methods that reduce risk and uncertainty in managing loans to SMEs. The lending decision is a process of interaction between the rules & head office instructions and a manager's experience, which explains the variation in decision outcome even with formal guidelines for the credit decision (Bruns and Fletcher, 2008). Banks can follow either a cookie cutter approach where strict and standardised quantitative criteria are used and more reliance is made upon collateral/ security and personal guarantees. Second way-out is following character lending approach where banks favour qualitative criteria based upon applicants' earlier credit history/ track record as well as their interactions with the loan officers.

SURVEY OF THE LITERATURE

Recent empirical evidence has found commercial banks as the main source

of external finance for SMEs (Cole et al., 1996; Petersen and Rajan, 1994; Berger and Udell, 2002; Ghosh, 2007; Ruis et al., 2009). But SMEs generally face difficulty in obtaining loans from them as financial providers have a lack of knowledge about the nature of the SMEs' business on the one hand and that many entrepreneurs had a lack of knowledge about the lending criteria and procedures of the banks on the other (Lean and Tucker, 2000). Banks generally follow three types of approaches while providing loans to SMEs. These are character lending approach, income based approach and capital based approach where asset backed security is required (Bruns and Fletcher, 2008).

In character lending approach, information is gathered that can inform banks about the chances of the borrower failing to repay the loan. Such information is typically associated with the characteristics of the borrower (Bruns and Fletcher, 2008). In this approach, variables like, age of entrepreneur, gender of entrepreneur, age of enterprise, entrepreneur's trading experience and his earlier track record with the bank are considered. Age of entrepreneur and enterprise has been found critical in loan making decision by banks as a funding gap has been found for early stage and younger entrepreneurs having up to 3 years trading experience and age below 30 years (Deakins et al, 2008; Deakins et al, 2010; North et al., 2010). Concerning gender of entrepreneur, women owned business are more likely to counter problems in accessing finance than their male owned counterparts (North et al., 2010). While Carter et al., 2007 argued although there is great deal of diversity in the criteria used to assess loan applications, for the most part, these do not vary by the sex of loan applicant. Trading experience has also been found as an important consideration of banks, failing to present the same reduces chances of getting loan from banks (Fletcher, 1995; Deakins et al., 2008). Similarly earlier track record of entrepreneur also plays an important role in loan approval decision of banks (North et al., 2010).

Banks are increasingly taking the view that lending decisions should be based on the cash flow, business plan and prospects, thus adopting an income based approach (Fletcher, 1995). Here financial performance, profitability of the project, business projections and risk & uncertainty are considered while making loans to SMEs. Financial performance is an important variable which is widely stressed upon while making loans to SMEs. Lending officers' probability of supporting credit increases with higher past financial performance of the borrowing SME (Fletcher, 1995; Bebczuk, 2004; Bruns and Fletcher, 2008). As far as risk & uncertainty and business projections are concerned, risk proclivity has a negative effect (Bruns and Fletcher, 2008; North et al., 2010) and good business projections have a positive effect (Bruns and Fletcher, 2008) on probability of granting credit

by banks. Relying upon highly certain plans is a part of uncertainty avoidance strategy followed by banks (Nguyen et al., 2010).

Where asymmetries of information exist, banks can adopt a capital based approach, which can also be called as cookie cutter approach, with an emphasis on gearing and financial assets (security) (Binks & Ennew, 1996). Asymmetric information exists in situations in which bank officers don't have 'perfect' information on funding proposals (Deakins et al., 2010). Here banks follow extreme conservative approach and check out the capital put in by entrepreneur himself as well as security/ collateral provided for backup. The firm's willingness to finance a larger part of the project by equity is viewed as a positive signal by the bank lending officer as it can be interpreted as a sign that the owner manager strongly believes in the success of the project secondly, it decreases the amount of external funding required further decreasing the credit risk of the bank (Bruns and Fletcher, 2008). The collateral is an integral and fundamental part of the lending package designed to secure the bank against default (Cowling and Westhead, 1996) as it is an alternative source of repayment for the bank and is liquidated if the borrower defaults. Banks' probability of supporting credit increases with an increase in the strength of the collateral supplied by the borrowing SMEs (Fletcher, 1995; Bruns and Fletcher, 2008; Cowling and Westhead, 1996; Deakins et al., 2010; North et al., 2010). Steijvers et al., 2004 documented loan amount and duration of loan with bank as main determinant of asking for collateral by banks. Bebczuk, 2004 put a different view and evidenced that acceptance of overdraft lines at higher interest rates and shorter maturity period is an important determinant of getting a bank loan, while the availability of collateral does not seem to affect such probability.

Nguyen et al., 2010 exhibited two types of strategies followed by banks while providing loans to SMEs. One is uncertainty avoidance strategy relying upon sufficient collateral, highly certain business plans, close monitoring and legally reported documents. On the other hand, is trust-based strategy which covers trustworthiness, collateral, business plans and documents monitoring. It was also evidenced that state owned banks tended to use uncertainty avoidance strategy more than do private banks which adopted trust based strategies.

Hence various studies have covered different approaches of commercial banks while financing to SMEs. In the present study, the researchers try to extend the literature by testing the following two null hypotheses in Indian context :

Hypothesis 1 : There is no significant difference in attitude of public and private sector banks while extending credit to SMEs.

Hypothesis 2 : There is no significant difference in decision making criteria of public and private sector banks while extending credit to SMEs.

DATABASE AND RESEARCH METHODOLOGY

Sample Design : The study is conducted in Ludhiana district of Punjab by using randomized convenience sampling technique for data collection. This district has been selected as it has the largest SME base in Punjab as well as it contributes maximum in terms of industrial production, fixed investment and exports. A sample of 71 respondents was taken from the branches of various public (39) and private (32) sector banks (including specialized SME branches). Respondents were either branch managers or senior loan officers having complete knowledge of decision making criteria, for SME lending, of their respective bank branches.

Data Collection Instrument : Primary data were collected through a structured questionnaire as well as personal interviews. A pre-tested structured questionnaire was developed to collect primary data which contained questions regarding bankers' attitude and decision making criteria while financing to SMEs, to be answered on a five point Likert scale ranging from 1 (Strongly Disagree) to 5 (Strongly Agree). Hence a schedule structured personal interview approach was used.

Statistical Techniques used for Analysis : Factor Analysis, Mean Scores and Independent samples T-test have been used to analyse the data and get inferences. Factor Analysis is basically used to condense larger number of variables into fewer dimensions and here, this technique has been deployed to explore the factors responsible for conservative approach of commercial banks as well as to identify the significant factors influencing their decision making criteria. Independent samples t-test has been employed to check the difference, if any, in the attitude and decision making criteria of public and private sector banks with respect to SME financing.

DATA PRESENTATION AND ANALYSIS

Overall Attitude of Commercial Banks Towards SMEs : Overall attitude of banks towards SMEs was studied on seven variables, to be answered on a three point Likert scale ranging from One (Never) to Three (Always). Table 1 documents the overall attitude of banks towards SMEs.

Table 1
Overall Attitude of Commercial Banks Towards SMEs

S. No.	Variables	Percentage Frequencies			Total
		Always	Sometimes	Never	WAS
1.	We provide loans to SMEs just to meet priority sector lending targets	43.7	28.2	28.2	2.15
2.	We serve SMEs as they are our profitable customers	59.2	32.4	8.5	2.50
3.	We follow conservative approach in providing loans to SMEs as these are more risky and result in Non-Performing Assets (NPAs)	11.3	53.5	35.2	1.76
4.	We always check collateral or security offered by SME entrepreneurs while applying for loan	64.8	31.0	4.2	2.60
5.	Loan provided is always 70-80% of collateral offered	21.1	66.2	12.7	2.08
6.	Decision of sanctioning loan is always taken by us at branch level	21.1	59.2	19.7	2.01
7.	Decision of sanctioning loan is taken at upper level if loan exceeds branch limit	83.1	16.9	0	2.83

It is evidenced from the above table that banks generally serve SMEs just to meet priority sector lending targets but on the other hand, they agree upon the fact that SMEs are their profitable customers (as WAS is 2.50). They follow a conservative approach as they are interested in checking security (95.8% cases) while raising finance to SMEs. It depicts contravention of RBI's guidelines of providing collateral free loans up to Rs. 10 lakh and up to Rs. 100 lakh under RBI's CGITMSE Scheme. Moreover, loan provided is generally 70-80% of the collateral offered (87% cases). Centralisation of loan making decision has been found in most of the cases if loan exceeds certain amount. The Weighted Average Scores (WAS) of the variables also concluded banks as back-seaters in SMEs financing. Comparison of Attitude of Public and Private Sector Banks towards SMEs: To compare the attitude of public and private sector banks, Independent Samples T-test was employed on the seven variables, used to measure the attitude of banks towards SMEs. Table 2 depicts the results of Independent Samples T-test.

Table 2
Independent Samples T-test on Overall Attitude/Approach

S. No.	Variables	Mean		t-values	P-values
		Public banks	Private banks		
1.	We provide loans to SMEs just to meet priority sector lending targets	2.10	2.22	.578	.565
2.	We serve SMEs as they are our profitable customers	2.56	2.44	-.812	.419
3.	We follow conservative approach in providing loans to SMEs as these are more risky and result in NPAs	1.49	2.09	4.599	.000*
4.	We always check collateral or security offered by SME entrepreneurs while applying for loan	2.33	2.94	5.565	.000*
5.	Loan provided is always 70-80% of collateral offered	2.00	2.19	1.365	.177
6.	Decision of sanctioning loan is always taken by us at branch level	2.26	1.72	-3.714	.000*
7.	Decision of sanctioning loan is taken at upper level if loan exceeds branch limit	2.90	2.75	-1.602	.115

* $p<0.01$, ** $p<0.05$, *** $p<0.10$

Above table shows that public and private banks have significantly different responses with respect to their approach and collateral policy. The mean scores suggest that private banks view SMEs as a risky sector as well as are more focused on collateral. Results negate the findings of earlier study of Nguyen et al., 2010 which concluded that public banks use uncertainty avoidance strategy (relying upon collateral/ guarantee and certain plans) more than do private banks which adopted trust based strategies.

REASONS FOR CONSERVATIVE APPROACH (RESULTS OF FACTOR ANALYSIS)

To explore the reasons for conservative approach of banks, they were asked to answer thirteen statements, on a five point Likert scale ranging from One (Strongly Disagree) to Five (Strongly Agree), regarding problems faced by them

Table 3

Reasons for Conservative Approach (Results of Factor Analysis)

Sr. No.	Factor-wise Dimensions	Factor Loadings	Eigen Value	%age of Variance Explained	Cumulative %age of Variance Explained
F_1	***Information Asymmetry***				
a.	Financial statements are not properly audited	.846			
b.	Quality of information supplied is not satisfactory	.772	2.239	17.224	17.224
c.	Limited financial information is available	.597			
F_2	***Collateral Deficiency & Rural Dispersion***				
a.	Small enterprises are unable to give guarantees of trusted parties	.752	1.973	15.178	32.402
b.	Small enterprises lack collateral/ security to offer	.740			
c.	Small enterprises have limited and dispersed rural markets	.659			
F_3	***Lack of Technical Skills & Experience***				
a.	Entrepreneurs are unable to make certain business plans	.671	1.947	14.980	47.382
b.	Entrepreneurs lack experience as they are young and at early stage	.603			
c.	Entrepreneurs lack managerial capabilities (technical and marketing skills)	.598			
d.	Small enterprises are generally located in rural areas	.581			
F_4	***Financially Deficient***				
a.	Small enterprises prefer longer payback period	.847			
b.	Small enterprises' capital contribution is less, they rely more on bank loans	.654	1.920	14.768	62.150
c.	There is always risk of NPAs	.607			

while raising finance to SMEs. Reliability analysis has been conducted and the Cronbach Alpha is determined as 0.736 which indicates reliability of the scale. Further, factor analysis is applied to thirteen variables. The value of KMO is determined as 0.631 and the Bartlett's Test of Sphericity as 255.129 (significant at 1%, $p < 0.000$) that justify the usage of Factor Analysis. Factor analysis has been performed using the principal component extraction method with varimax rotation, on the basis of Eigen value not less than one for any factor. Table 3 shows the results of the Factor Analysis by depicting rotated values of factor loadings, Eigen values, percentage of variance explained by the factors extracted and cumulative percentage of variance explained. Nomenclature of the factors extracted has been given on the basis of highest factor loadings of the variables loaded onto a particular factor.

Above table exhibits the results of factor analysis by documenting four factors resulting in conservative approach of banks. Three items have loaded on 'Information Asymmetry' factor with variance of 17.224%, 'Collateral Deficiency & Rural Dispersion' with three items contributes a variance of 15.178%, 'Lack of Technical Skills & Experience' accounts for 14.980% variance with four items and 'Financially Deficient' explains 14.768% variance with three items, altogether explaining cumulative variance of 62.150%. Hence the most important reason of conservative approach of banks has been found as 'Information Asymmetry'. This finding confirms that of Bruns and Fletcher, 2008 and Deakins et al., 2010 who found that Information asymmetry leads to demanding collateral by banks and in some cases, reluctance of banks to provide credit to SMEs. Cowling and Westhead, 1996 also concluded that lack of information about small firms increase the cost of raising finance to them. The next important reason of conservative approach was found to be Collateral Back up & Rural Dispersion. This finding is in line with studies by Bruns and Fletcher, 2008; Deakins et al., 2008 and North et al., 2010 who also reported lack of collateral or security as main reason for rejection of loan request of SMEs. Hence SMEs should provide banks with adequate and quality information to remove this barrier in raising finance.

Comparison of Public and Private Sector Banks : To check whether public and private sector banks differ in their reasons for following a conservative approach, Independent Sample T-test has been deployed on the mean scores (non refined factor scores) of factors extracted by Factor Analysis. The results of which are shown by the Table 4 below which indicates that both public and private sector banks agree upon the same reasons for adopting a conservative approach (as no factor has been found significant).

Table 4

Independent Samples T-test on Reasons for Conservative Approach

S. No.	Variables	Mean		t-values	P-values
		Public Banks	Private Banks		
1.	Information Asymmetry	3.25	3.29	.166	.868
2.	Collateral Backup & Rural Dispersion	2.84	2.67	-.952	.344
3.	Lack of Technical Skills & Experience	2.43	2.62	1.423	.159
4.	Financially Deficient	3.38	3.42	.179	.858

*p<0.01, **p<0.05, ***p<0.10

Cookie Cutter vs. Character Approach in Decision Making : Comparison of Public and Private Sector Banks: The credit process represents a critical bank function. Here banks combine different factors in their credit assessment but not with the same importance. Banks can follow either a cookie cutter approach where strict and standardised quantitative criteria are used and more reliance is made upon collateral/ security and personal guarantees. Second way-out is following character lending approach where banks favour qualitative criteria based upon applicants' earlier credit history/ track record as well as their interactions with the loan officers. Thus, an attempt has been made in the forthcoming section to compare the public and private sector banks with respect to their approach while extending credit to SMEs. For the same, the responses of both public (39) and private (32) sector banks were taken on fourteen variables, considered while loan decision making, on a five point scale ranging from 'Very Important' to 'Least Important'.

The research instrument has been tested for reliability using composite Cronbach's co-efficient alpha and its value is determined as 68.2%. In order to provide a more parsimonious interpretation of the results, factor analysis has been performed to reduce the number of variables. The data have been examined with the help of Kaiser-Meyer-Olkin (KMO) measure of sampling adequacy as .605 and Bartlett's Test of Sphericity as 218.203 (significant at 1%, $p < 0.000$) and are found appropriate for factor analysis.

A Principal Component Method with varimax rotation of the fourteen variables reveals five underlying factors with Eigen value greater than one. These five factors explain 64.351% of the variability in the fourteen variables. The criterion used for identifying factors was to delete any item with factor loading less than ± 0.30 but all the factor loadings are far more than the criterion adopted. Table 5 documents the results of the Factor Analysis by depicting rotated values of factor

loadings, Eigen values, percentage of variance explained by the factors extracted and cumulative percentage of variance explained. Nomenclature of the factors extracted has been given on the basis of highest factor loadings of the variables loaded onto a particular factor.

Table 5

Decision Making Criteria (Results of Factor Analysis)

Sr. No.	Factor-wise Dimensions	Factor Loadings	Eigen Value	%age of Variance Explained	Cumulative %age of Variance Explained
F_1	***Loan Characteristics***				
a.	Loan Size	.799			
b.	Source of Repayment of Loan	.775	2.329	16.634	16.634
c.	Loan Payback Period	.587			
F_2	***Financial Profitability & Collateral Backup***				
a.	Financial Projections & risk of Plan	.746			
b.	Turnover and Profitability of Enterprise	.699	2.116	15.116	31.751
c.	Financial Records of Enterprise	.664			
d.	Collateral & guarantee offered	.587			
F_3	***Margin Money & Earlier track Record***				
a.	Percentage of Capital put in by entrepreneur himself	.851	1.688	12,056	43.807
b.	Earlier Credit History	.765			
F_4	***Entrepreneurial Characteristics***				
a.	Gender of Applicant	.690			
b.	Age of Entrepreneur	.676	1.478	10.558	54.365
c.	Age of Enterprise	.530			
F_5	***Entrepreneurial Skills & Purpose of Loan***				
a.	Qualification and Technical Expertise of Entrepreneur	.818	1.398	9.986	64.351
b.	Purpose of Loan	.637			

Five factors explaining 64.351% of the variation in data, have been identified as 'Loan Characteristics', 'Financial Profitability & Collateral Backup', 'Margin Money & Earlier track Record', 'Entrepreneurial Characteristics' and 'Entrepreneurial Skills

& Purpose of Loan'. Further, mean scores of five factors have been calculated and Independent Samples t-test have been deployed to compare the decision making criteria of public and private sector banks, the results of which are shown in Table 6

Table 6

Independent Samples T-test on Decision Making Criteria

S. No.	Variables	Mean		t-values	P-values
		Public Banks	Private Banks		
1	Loan Characteristics	3.97	4.31	2.147	.035**
2	Financial Profitability & Collateral backup	4.19	4.68	4.992	.000*
3	Margin Money & Earlier track Record	4.60	4.75	1.092	.278
4	Entrepreneurial Characteristics	3.27	3.35	.621	.537
5	Entrepreneurial Skills and Purpose of Loan	4.205	4.109	-.612	.543

*p<0.01, **p<0.05, ***p<0.10

Above table exhibits that public and private sector banks have significantly different decision making criteria for sanctioning loans to SMEs. They differ significantly on 'Loan Characteristics' i.e. loan size, its payback and repayment source and 'Financial Profitability & Collateral Backup'. The mean scores suggest that private banks attach more importance to these variables than do the public banks. It can be concluded that private banks are more conservative as they are following strict quantitative criteria and are more reliant upon loan characteristics, collateral and guarantees where as public banks are attaching more importance to entrepreneurial skills and expertise. Hence private banks are using Cookie Cutter Approach where as public banks are following a Character Lending Approach.

CONCLUSION

The present study has been carried out to analyse the overall attitude of commercial banks towards SMEs and to compare public and private sector banks with respect to their decision making criteria while extending credit to SMEs. The study identified conservative approach of commercial banks towards SMEs. Banks are reluctant to provide loans to SMEs. Moreover, SMEs are pegged back by high interest rates as amount taken on loan by them is smaller. Furthermore, banks are

not providing adequate cash credit limit for working capital as it is supposed to be 20% of projected sale figure of approved project report but banks are not willing to raise the same for MSMEs . Loan settlement policy is also not implemented by most of banks as RBI has given directions to give collateral free loans up to Rs 10 lakh to MSEs but banks are reluctant to follow the same . Moreover, scheme of granting collateral free loans up to Rs 100 lakh to units under CGITMSE scheme is also not implemented by banks . Reasons for this conservative approach have been found as 'Information Asymmetry' and 'Collateral Deficiency & Rural Dispersion' of micro, small and medium enterprises.

Public and private sector banks differ in their decision making criteria as private banks are following a strict quantitative criteria by showing more concern for loan amount & it's payback, profitability and collateral or guarantees offered and hence following a COOKIE CUTTER APPROACH whereas public sector banks are attaching more importance to expertise and skills of entrepreneurs and hence following a CHARACTER LENDING APPROACH.

IMPLICATIONS OF THE STUDY

1. Information asymmetry has been found as the main reasons of conservative approach of commercial banks towards SMEs. Hence, small and medium enterprises should provide adequate and quality information to banks so as to remove this greatest barrier while raising finance from banks.
2. Banks are reluctant in providing collateral free loans (as they check for collateral while extending credit to SMEs) in spite of RBI guidelines on collateral free loans as well as under CGITMSE scheme. They have their own reasons as it is difficult for them to extend a loan to a new customer without any collateral or guarantee. They can extend collateral free loans only to old customers having good track record where these RBI's guidelines on collateral free loans don't find validation as customers having good track record can get collateral free loan even without RBI guidelines. So, RBI should take steps to validate these type of schemes.
3. Private Banks have been found as more conservative as there are no sub-targets for micro, small and medium enterprises under priority sector lending. There should be some sub-targets for private banks also as in the case of foreign banks.

LIMITATIONS AND FURTHER RESEARCH

The findings of the study are subjected to certain limitations. (a) The study is confined to only one district of Punjab. (b) Sample size is small (c) The study has covered public and private banks only (d) The study is based on primary survey which has been conducted through a structured questionnaire. The respondents might have given deliberately the responses which they actually might not have experience and hence, subjectivity might be present in the responses. In order to contribute greatly to the existing body of knowledge, it is recommended that a) similar future research could be conducted by collecting data from other states of India with larger sample size; b) the study can be further extended by adding foreign banks to the study.

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