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Research Article

Bankers' Perceptions of Successful SMEs Loan Applications: A Case Study from Libya

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Abstract

This paper investigates the criteria used by loan officers at *Bank Al Tanmeya* when assessing SMEs loan applications and the most frequent reasons that lead to turn these applications down. To achieve this, a qualitative research method was adopted. The data were gathered using semi-structured interviews with loan officers at the bank. The results show that the ability to provide collateral and good business plans alongside the profitability of the business are very important. Other criteria such as the applicants' credit history, their business experience and the type of business activity are also important. Further, the results indicate that SMEs loan applications are generally rejected on the ground that they are not robust enough from the bankers' viewpoint. While lack of collateral is the most frequent reason, other reasons include weaknesses in business plan, concerns about the loan repayment, and doubts about the viability of business ventures. These results have the ability to increase awareness and broaden understanding of the factors that may affect SMEs access to bank loans from a supply side perspective.

Keywords: Lending criteria, SMEs, Libya.

Introduction

Small and medium-sized enterprises (SMEs) are of increasing importance for all national economies worldwide. Evidence already shows that these entities are critical in a number of key economic areas, including the distribution of income, the absorption of labour and the alleviation of poverty. As a result, SMEs have been increasingly the focus of policies and strategies aiming at achieving sustainable development goals in both developing and developed countries, regardless of any pre-existing differences in their underlying economic systems. However, despite the widespread developments in recent decades, the lack of access to finance

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remains a formidable obstacle in the development path of SMEs. This is because lending institutions are reluctant to finance these firms because of their size, high risk of investment, and the level of information asymmetry.

Access to finance has remained one of the key problems that keep confronting SMEs. There is wide agreement that the creation and growth of healthy and thriving SME sector are directly related to the ability to access to finance. As such, governments around the world have been supporting SMEs access to finance by addressing legal and regulatory barriers and building credit infrastructure. Despite the fact that much of the finance used by SMEs is internally generated by businesses out of their owners' savings and retained earnings, banks remain the most common external capital provider for such firms in both developed and developing countries mostly in the form of overdrafts and short term loans.

In practice, providing finance for SMEs can be uncertain task for banks considering the high risk resulting from asymmetric information effects. Taking this into account, the key issue is the one concerning the extent to which SMEs are credit constrained or, more strictly, credit rationed. In this context, Berry *et al*. (1993), explain that banks make lending decisions to SMEs under conditions of uncertainty and asymmetry of information. Therefore, a successful strategy for lending to SMEs is the one that guarantees tailored financial products to meet the specific SMEs needs whilst, in the same time, can deal and cope with the associated problems and risks.

In this context, credit officers would examine SMEs characteristics and evaluate their creditworthiness to help in deciding whether to approve or reject their loan proposals (Chandler and Coffman, 1979). Creditworthiness is "a characteristic of an individual that makes him or her suitable candidate for the extension of credit, while someone who is not creditworthy is, conversely, unsuited to credit" (Lewis, 1992, p.3). In simple words, creditworthy applicants pay all their obligations as agreed in the credit terms/conditions and those who are not do not. Therefore, creditworthiness implies the applicant's ability/willingness to repay the loan.

According to Stanton (1999), in case the creditworthiness of an applicant is opaque, credit officers would either increase interest rates charged to offset the extra risk or put extra effort into determining what information can add value, and how to acquire and assess them. Eventually, the decision as to whether or not to approve the loan proposal is based, to a large extent, on the credit officers' experience and personal knowledge (Hand, 1998). In this approach, rules and other non-empirically derived credit guides established by the bank's policies might be also combined (Chandler and Coffman, 1979). As such, the lending decision is a process of interaction between the rules and the credit officers' experience.

The lending process entails series of activities in which two principal parties the lender (credit officer) and the borrower are involved. The association between the two ranges from the initial lodge of the loan proposal to the full loan repayment. Basically, it encompasses the following (i) loan application (ii) credit analysis (iii) credit decision (ix) loan review. In this process, credit analysis is the most important. This is because it is the basis on which lending decisions are to be made. Credit analysis refers to the bankers' effort to examine factors that may lead to a default in the loan repayment. Therefore, the ultimate objective of credit analysis is to determine a borrower's ability and willingness to repay a loan (Shamsudin, Shamsher and Annuar, 1988).

In Libya, after a period of dominance by state-owned large companies, SMEs have been recently receiving more attention as engines for the private sector development in order to alleviate oil and hydrocarbon dependency, and help in the restructure of the national economy. Although Libyan SMEs represent a significant portion of Libyan firms, they have relatively low value-added (Elmansori and Arthur, 2014). This is because of a number of challenges hindering their growth. Difficulties in obtaining funding is the most highlighted. According to The World Bank's (2011) Investment Climate Assessment, more than 50 percent of Libyan SMEs perceive access to finance as a major or very severe constraint.

Banks are by far the strongest player in the Libyan financial system. They represent almost the only source of finance that can provide individuals as well as businesses with loans. However, they only lend on a short-term basis mainly to low-risk activities. In addition, banks limit their activities to collateral-backed loans. This explains why it has been reported that the Libyan economy is characterised by low levels of financial intermediation (OECD, 2014). Moreover, Libya is ranked the 101th of 144 countries on ease of access to loans according to the 2011-2012 Global Competitiveness Report (Schwab and Sala-i-Martín, 2012). Porter and Yergin (2006) reported that the Libyan private sector especially SMEs lack access to banking capital. Eltaweel (2012) concluded that the Libyan banking sector does not work well for SMEs as banks are often reluctant to disburse loans to this sector.

The existing literature is clearly an important source of information in developing an understanding of bank financing for SMEs. Nonetheless, it is dominated by demand side studies while the supply side has been almost an overlooked area of investigation especially in developing countries like Libya. Previous studies (e.g. Deakins and Hussain, 1994; Hatch and Wynant, 1995) found that SMEs were deprived of funds due to lack of understanding on the part of bankers. Given the increasing important role of SMEs in the national economy, SMEs financing is one of the most interesting and appealing areas to study.

Objective of the study

Employing *Bank Al Tanmeya* as a case study this paper aims at achieving two objectives. First, to explore the factors that bankers consider when making decisions regarding business loans to SMEs in Libya. The study also seeks to identify the main reasons leading to SMEs loan applications to be declined.

The rest of the paper is organised as follows; the next section reviews the related literature. The research methodology is described in the following section. The subsequent section presents the empirical results. The last section is dedicated to the study's conclusion, contributions, limitations, and suggestions for further research.

Literature Review

When lending to SMEs, banks face high risk (Le and Nguyen, 2009; Blackwell and Winter, 2000). As a result, banks approach SMEs differently than they do with larger businesses. Before making a decision to lend to SMEs, banks have to evaluate the information about prospective borrowers to determine their creditworthiness. Traditionally, this is based on the bankers' experience and skills in applying basic lending principles. Bankers conventionally take their knowledge of the borrowers and their business market and combine this knowledge with limited financial information provided by borrowers to make lending decisions. Jankowicz and Hisrich (1987) claim that "commercial loan decisions involve both specific, quantifiable information and subjective, qualitative judgements" (p. 45). As the precise lending principles and assessment criteria vary between banks, a number of studies were conducted to determine the relative importance of these criteria. The most common criteria reported in the academic and practice literature are briefly discussed in this section.

Fletcher (1995) examined the criteria used by Scottish bank managers to lend to SMEs by interviewing a sample of bank managers. The respondents were asked about the process of decision-making and how lending decisions to SMEs are made. The study concluded that the management capabilities of owner-managers are the most important factor when considering funding SMEs. This was followed by the business location and the source of repayment. Gearing and the use of chartered accountants were also important. Interestingly, the qualifications of owner-managers and their experience were found less important.

Another Scottish-based study was undertaken by North *et al*. (2008) with the aim to provide detailed insight into supply-side processes relating to SMEs bank finance. In this study, eight bank managers at different seniority levels in three of the four major Scottish commercial banks were interviewed. There was a consistent agreement among the interviewees that some criteria such as the owner-manager's knowledge of the business, previous trading history, authorised accounts, profitability and track records are very important. However, there was some variation in the importance attached to some personal factors such as the owner-manager's age, gender and experience. The availability of security was considered of secondary importance.

The authors attributed the variations between the bankers in the importance attached to different criteria to differences in their seniority as well as to different internal processes within the participating banks. They concluded their study by summarising the important lending criteria as follows:

- The management track record of the management team.
- The personal relationship with the local bank manager.
- Location of the business.
- The financial history of the firm including the trading accounts for the last three years.
- Business sector, particularly if some sectors are "out of favour".
- Existing SMEs clients should have easier access to bank finance.
- Security is perceived as a secondary factor; however, it is a factor that could be important for 'high risk' lending situations with some SMEs.

In the US, the principles of lending comprise of what is known as "5Cs" namely; character, capacity, capital, collateral and condition (Sinkey, 1998; Jankowicz and Hisrich, 1987). Character is related to desirable ethical matters such as honesty, integrity and trustworthiness. It refers to the borrower's willingness and determination to meet a loan obligation. The borrower character might be assessed based on his/her past experience, his/her conduct during the interview and how he/she paid previous obligations. In addition, suppliers, customers and creditors can provide valuable insights into the character of a prospective borrower (Ruth, 2004). Rose (1993) believes that such assessment can demonstrate the borrower's responsibility and seriousness for requesting the loan and his/her seriousness to repay. Shanmugam, Hempel and Turton (1992) mentioned that successful bank lending can be ascribed to good assessment of the borrower's character.

Capacity is the second "C" in the lending criteria. It should indicate the borrower's ability to generate and manage cash to satisfy all loan obligations. In simple words, it is the ability of the borrower to repay the loan. The main purpose of the assessment of capacity is to determine whether a borrower is creditworthy. For bankers, capacity is very critical as it represents the primary source of the loan repayment. Barona (1985) maintained that capacity is dependent on the borrower's future cash flows which, in turn, depend on other fundamental factors such as the internal management of the firm, the industry environment and the general economic environment.

The third "C" is capital. Capital represents the funds retained in the firm to provide a cushion against any unexpected losses. An important consideration here is the amount of capital reserves which owner-managers are willing to inject into the business if necessary (Ruth, 2004). The assessment of capital involves determining how much the bank can get if the business is liquidated or went bankrupt. When assessing the capital, a special consideration should be given to the applicant's ownership in the firm in relation to the loan requested (Dorfman, 1991). This could ensure the banker that the borrower with a significant stake in business would be a prudent user of the loan money.

The fourth "C" is the one that refers to collateral. Collateral is the asset/s to be pledged to secure a bank loan. It can be in the form of inventory, accounts receivable, machinery, or real estate. From a theoretical point of view, there are two alternative interpretations why banks require collateral when lending to SMEs. On the one hand, it is the problem of adverse selection. The security offered by pledging collateral can help alleviate this problem (Chan and Thakor, 1987; Stiglitz and Weiss, 1981). This can be interpreted as a signal that eliminates the adverse selection problem when assessing the loan application. On the other hand, an alternative interpretation is that collateral is required to mitigate the moral hazard problem once the loan is granted. As such, collateral becomes a means to discipline the borrowers' behaviour to ensure the success of the project for which the loan was granted (Aghion and Bolton, 1992).

The last "C" is conditions. It refers to the environment in which the borrower's firm operates. The assessment of condition should include factors that may affect the probability of the borrower to repay the loan. It focuses on the borrowers' vulnerability to changing conditions and their ability to cope with them (Sinkey, 1998). Not only do conditions refer to those related to the borrower but also to bank-related conditions. Examples of the changes in the borrowers' business environment include; changes in demand, supply of raw materials, prevailing technology, suppliers, customers, labour regulatory and local employment conditions. The bank-related conditions can be exemplified by any changes in interest rates, credit risk, liquidity risk, the bank's credit policy and changes in trends in the industry.

In addition, other researchers have attempted to enrich the existing literature on SME lending criteria. For example, two more "Cs" referring to competition and costumer relationship were added by White (1990). Moreover, Cooper (1975) suggested four "Ps" to be used in the lending assessment process. They stand for; people, purpose, protection and payment. People indicates the assessment of the character of the borrower. Purpose involves a judgment of the benefits of the borrower's business. Protection refers to the detailed analysis of financial information as well as attaining security, while payment is about examining the firm's future cash flows as a source of repayment.

In developing countries, Harif, Hoe and Zali (2011) conducted a study to answer the question what aspects Malaysian bankers consider when evaluating SMEs finance applications. Interestingly, 15 factors were identified, comprised of 3 factors as financial factors and 12 factors as non-financial factors. These factors were further categorized into core factors (7 factors) and supplementary factors (8 factors). Examples of the criteria found in addition to the traditional 5C's include; financial statements, strategic planning, industry analysis and competence management.

In the African context, in order to understand the decision-making process in granting loans to SMEs in Ghana Agyapong, Agyapong and Darfor (2011) investigated the criteria used by local bankers in assessing SMEs loan applications. Their results indicated that when deciding on whether to accept or reject SMEs loan applications, bankers highly rank criteria such as purpose of loan, repayment of previous loans, type of business and collateral availability. However, other criteria such as CVs of clients and gearing were less important.

At the other end of the scale, factors that may lead to reject SMEs loan proposals have been the focus of research in SMEs-bank finance literature. For example, the study by Buttner and Rosen (1992) revealed some reasons that might lead

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bankers to decline SMEs loan applications. These reasons included; insufficient collateral, bad timing, lack of managerial and entrepreneurial skills, insufficient market research and poor business plans. An earlier study by Fertuck (1982) identified several factors that contributed to rejecting SMEs loan applications by credit officers. Ranked in order these factors were; poor credit rating, lack of competence, poor cash flows, poor market for product/service, inadequate collateral and fraud and bankruptcy risks. Read (1998) found that the main reasons for declining SMEs loan proposals are those pertaining to lack of collateral, insufficient turnover and poor cash flow.

Struck and Glassman (1983) concluded that refusing of SMEs bank loan applications can be attributed to factors such as: not enough owner-manager's equity in the firm, no track records, poor collateral quality, poor earning records and bad credit history. Slightly different reasons were reported by Barrett (1990). His study found that the reasons for rejecting SMEs funding applications were: owner-managers' poor communication with bankers, over-optimistic proposals exceeding industry projections, rapid expansion of the business as against the capital available and misuse of loans in the past.

In the study of Harif, Hoe and Zali (2011) the participant bankers were asked to identify the factors that cause SMEs loan applications to be rejected. The results showed that the main reasons were: poor presentation in financial statements, not enough indicators of capacity, the inability to generate enough income, poor management skills, lack of experience and other industry-related factors. In addition to the most frequent reasons cited in the literature, Desmond (1991) listed other reasons which he called performance factors. Under this categorization he cited factors such as too high gearing, cash flow records, level of profits, poor presentation and insufficient knowledge of finance.

Methodology

In order to achieve the aim of this study which is gaining in-depth insights and understanding of the criteria used by bankers to lend to SMEs, a qualitative research method was deemed the most appropriate. Qualitative research approach is a process of inquiry to understand a social or human problem based on building a holistic picture formed with words, reporting detailed views of informants and conducted in its natural setting (Creswell, 1994). Focusing on the meanings, experiences, and description, qualitative research approach can be described as "subjective" in nature (Naoum, 1998). In other words, qualitative research is about finding answers to questions beginning with why, how and what. Therefore, it can be inferred that qualitative research is an attempt to increase understanding of why people act the way they do and why things are the way they are in their field of study which applies to this study regarding the criteria of lending to SMEs.

The data for this study were obtained using semi-structured interviews. The reasons for choosing this type of interviewing are; first, it has a capacity to gain large amount of in-depth data in a relatively short period of time, and immediate follow up and clarification are possible (Marshall and Rossman, 2010). Second, it allows the researcher to generate his/her own questions to develop interesting areas of inquiry while the interview progresses (Ghauri, Grønhaug and Kristianslund, 2008). Finally, it provides insights into the previous history of the situation as well as current activities (Yin, 2009).

The interview questions were developed from the relevant literature. A number of prominent senior loan officers within *Bank Al Tanmeya*, a state-owned bank that considers SMEs its primary market, were interviewed. Interviews took the form of conversations between the researcher and the respondents and lasted from 30-70 minutes duration. Participant bankers were asked to discuss the several criteria they consider when assessing loan applications from SMEs clients. Although the size of the sample was relatively small (seven interviewees), a major advantage obtained from this sample is that the participants were among key decision-makers with respect to bank lending criteria to SMEs.

Unlike quantitative data, qualitative data may not be sufficiently precise to allow statistical analysis or use of any software to build matrices. Therefore, the interpretative method in a manual manner was utilised in analysing responses obtained during the interviews. To aid the analysis, the data gathered were transcribed, translated, collated, classified, summarised, and analysed into meaningful categories to achieve the aim of the research questions being addressed. This method is most suitable when "rich" information about a small number of subjects is needed, when a flexible or informal approach is desirable or when members of the sample population involved are better researched by encouraging description and analysis of situations in their own words (Ticehurst and Veal, 2000) which was the case regarding data related to the topic of investigation in this paper.

Findings

The interviews had focused on gathering information on the eligibility criteria which loan officers at *Bank Al Tanmeya* consider when making decisions on accepting SMEs loan applications and reasons for such applications being rejected. The findings reported in this section are based mainly on the interpretations of the interviews and observations made by the researcher during discussions. Wherever applicable, narrative quotations are used to illustrate the arguments and the findings.

The discussions revealed that a number of criteria are considered when assessing SMEs loan applications. According to the interviewees, SMEs' business proposals and loan applications are considered case by case. In this respect, some criteria are given more importance than others. As the credit decision-making essentially entails bankers assessing the risk involved with SMEs lending propositions and to attain more realistic insights of this process, this section is divided into two sub-sections. Accordingly, the discussion of the factors that influence the credit decision is divided into financial risk factors and non-financial risk factors.

Financial Risk Factors

The Profitability of the Business

In general, under normal circumstances banks will grant loans to profitable or potentially viable business. In this respect, SMEs are no exception. The findings revealed that the profitability of the project for which the fund is being sought seems to be a top factor. Profitability here means that the granted loan must generate profit for the bank. The bankers' argument implied that they were interested in the ability of the potential applicants to generate profit. They pointed out that profitability is very important in determining the success or failure of a business. They further indicated that the profitability of a business reflects its true position and thus demonstrates its capability to repay the loan. In other words, from the point of view of the interviewees the ability to generate profit is sought as an indication of the applicant's business ability to generate enough profit to repay both the principal loan and the interest. One interviewee stressed that:

"It is very important to explore whether the project to be funded is profitable for the bank or not. As such, there is a need to assess the profitability of the project. If the project has a good indication of certain profitability it will be more likely provided with the fund".

It was also found that business plans supporting loan application are expected to include indications for the growth and profitability of the business. Almost all the participants agreed that profitability ratio is viewed as an important variable to identify and measure the SMEs creditworthiness. This result seems to support the conventional view that firms that have a higher level of profitability will have a better chance to access bank loans.

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In addition, it is worthy to mention that the discussion with some of the bankers regarding the profitability revealed that the profitability of the business would be assessed in a number of ways. However, they emphasised that the ultimate objective is to judge the viability of the business and the ability of the potential borrower to repay the loan. They also emphasised that profit figures of the business should not be looked at in isolation. They explained that such figures should be observed in terms of trends. These trends could include profit figures, profit margins, profit trends, trends of sales and also any losses in the past. This information can be obtained from other sources such as personal interviews with applicants and the bank's visibility study. From the point of view of the bankers altogether these figures can lead to a better understanding of the true performance of the business and therefore a better judgement of the creditworthiness of the applicant.

The Provision of Collateral

The findings revealed that in assessing SMEs loan applications the existence of collateral is vitally important. There was an agreement between the interviewees in their views that collateral security is central for considering SMEs loan applications. It was indicated that the provision of collateral is a requirement by the bank's credit policy. Moreover, it was inferred that if no collateral can be provided, then the probability of rejecting the loan application is very high. That is to say loans to SMEs clients, in general, have to be secured.
The following quotation from one banker demonstrates the importance of collateral to process the loan application:

"Generally speaking, all applicants have to be able to provide collateral. I know that providing good collateral is a challenge for most of these businesses, but that is something we have to consider… There are policies and guidelines to follow. Customers have to understand that the bank needs to feel safe".

According to the interviewees, collateral requirements usually are in the form of physical fixed assets especially real estate, land, machinery and equipment. However, in some cases personal guarantees/commitments are also accepted.

The discussions also revealed that provision of collateral is required before loans could be granted to SMEs. In some cases, an SME applicant can be also asked to pledge supplementary collateral if the value of the primary collateral (generally real estate) is not sufficient. This supplementary collateral can be personal guarantees or other forms of movable properties. One respondent explained that collateral of tangible nature such as real estate, machinery and equipment pledged by SMEs clients must go through an evaluating process prior to be accepted. This process is done by a team of experts under the supervision of the local court.

The interviewees were further asked about the main kinds of collateral accepted to process SMEs loan applications. Their responses can be summarised as below:

- Real estate: the most popular and the main type of collateral which is usually required.
- Machinery, equipment and vehicles: this type of collateral is usually required from SMEs clients operating in manufacturing and transportation.
- Products and goods (inventory): this type of collateral should be protected from damage and immune to changes in supply and demand.
- Personal guarantees: usually in the form of securities and letters of exchange and can also be the

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borrower's own salary or bank deposits.

- Any other types decided by the bank.

During the discussions regarding the importance of providing collateral for assessing SMEs loan application, the participants were asked whether the provision of collateral by SMEs means charging less interest rate. Their answers indicated that the interest rate charged by the bank on loans to SMEs is a fixed rate regardless of the value or the quality of the collateral provided. They pointed that the demand for collateral is to reduce moral hazard and adverse selection problems and to demonstrate the ability and willingness of the applicant to repay the loan with the interest on time and has nothing to do with the terms of the loan. One interviewee commented that collateral is viewed as an indicator that the applicant has the intention to use the loan for the purpose specified in the loan application which can then increase the security margin for the bank, nevertheless, the applicant still has to repay the loan with the stated interest rate.

Consequently, it could be understood that the provision of collateral does not lead to better credit terms for SMEs nor to the approval of loan applications that otherwise could not be granted. Furthermore, it was mentioned that the inability to provide collateral is an important factor that may lead to the rejection of SMEs loan applications. Finally, there was no evidence to suggest that long relationships with the bank do reduce collateral requirements.

The Applicant's Credit History

Credit history here refers to the past experience of SMEs customers in repaying their loans. In this context, the nature of the credit history of the client is viewed as an essential piece of information by most respondents. The majority of the respondents were of the view that such historic information is equally important as projections for existing businesses. Those bankers perceived good records of loan repayment of SMEs clients as a positive sign for taking the funding applications further. On the other hand, all of the interviewees agreed that clients with bad credit history would be more likely denied funding and eliminated at early stages of the process. One banker commented that:

"From my perspective, credit history of the clients is important and it can directly or indirectly have some effects on the loan application assessment process. I look at this quality not only as an indicator of the client's commitment and success in meeting repayment requirements in the past but also as an indicator of his/her willing to pay back the loan if granted. It also can indicate how the client is managing the business effectively or otherwise".

Whilst most of the interviewees stressed that they consider clients' credit history as critical, some others were less firm in this regard however. Some interviewees stated that they are interested in information related to the applicants' credit history, nonetheless, they would be willing to proceed with the applications even if such information is not provided as long as other "*top*" criteria such as collateral requirements and convincing business plan…etc. have been met. Their argument was that the payment capacity of the firm and securities are more important than historical figures. This view also may reflect some flexibility that some loan officers have when dealing with businesses that have not been trading long enough and thus have limited credit records such as start-ups.

As sourced from the interviewees, it is worth mentioning that the importance of information relating to credit history is not confined to previous loan activities with *Bank Al Tanmeya*. The discussions revealed that such information is equally important with regard to loan activities that SMEs applicants had with other banks. This means that more information is needed on businesses that had or are having existing dealings with other banking institutions.

Financial Statements

In theory and practice financial statements are critical and play a key role in lending decisions made by banks. Regarding this, the interviewees were asked to comment on how important financial statements are in the process of appraising SMEs lending applications. Their responses indicated that in general financial statements are important elements in lending decisions; however, in the case of SMEs the story is rather different. There was an agreement among the bankers that financial statements are not vital for the lending application approval process. The interviewees mentioned that financial statements are requested only when they are available. This argument is supported by the fact that most SMEs do not have financial statements and, if any, only a very small minority would have them audited or certified. The respondents argued that even if the financial statements of the business are audited that does not mean that they would be accepted for granted, they rather would investigate them and discuss the details with the applicant.
One interviewee said:

> *"When dealing with SMEs borrowers you cannot expect them to have proper financial statements. They are just not reliable. In most cases they are prepared for avoiding taxes and do not give an accurate picture of the health of the business…. When it comes to the interview discussing some of the figures in the statements is a regular part".*

Interestingly, some of the bankers stated that they would not ask SMEs clients for their firms' financial statements if it was not there in the bank's policy credit. According to *Bank Al Tanmeya'*s policy credit SMEs applicants are asked to provide balance sheets and income statements if they are available. These particular bankers argued that there are other aspects that matter more for the loan application approval. Their argument was based on their experience that if the project has a good business plan and can satisfy the other requirements such as security/collateral it is highly likely that the loan application will be processed without taking into account the information in financial statements.

It could be understood that since the majority of SMEs do not have reliable financial statements, the bankers cannot entirely rely upon financial reports to process lending applications. This is not surprising given the very informal business culture that the country has which results in incomplete and unreliable financial statements. Nevertheless, as indicated by some interviewees in the absence of trusted reliable financial statements, the availability of security collateral and a convincing business plan could be key factors in the approval process.

Non-Financial Risk Factors

Supporting Business Plan

It is acknowledged in the literature that business plan is strategically important in bridging the gap of information asymmetry problems in SMEs lending. In the same vein, in this study the provision of a business plan seems to be among the top lending criteria identified during the interviews. The majority of the bankers argued for the significance of a good business plan supporting the loan application in the evaluating process. They emphasised that a well-prepared business plan can reflect some aspects serving in assessing the applicant's creditworthiness. One interviewee explained that for taking forward the loan application it has to be supported by a written business plan which explains some business aspects such as predictions of cash flow, sales forecasts in addition to profitability ratios for instance. Moreover, another loan officer interviewed stressed that to process the loan application a good business plan is a "crucial element". In the words of this interviewee:

"Business plan is a key to better understand the clients' business. A full business plan incorporating financial forecasts and

growth intentions is a crucial element to justify the lending application".

The same interviewee stressed and maintained the importance of a full and convincing business plan by adding:

"Among other important factors, presenting a full business plan is a good indication of the eligibility for accessing bank loans. Generally, clients with better business plans have a big advantage over others who do not".

The discussion of the importance and the role of business plans to process SMEs loan applications raised the question about what a good business plan should include. Consequently, the interviewees were asked what they in general expect to see in a good business plan presented by SMEs when assessing their lending requests. There was some variability between the interviewed bankers in answering this question. However, in general, their views implied that a good business plan should basically provide information which is mostly of financial nature. Such information, according to the interviewees, include, for example, profitability ratios, growth ratios, liquidity related ratios, variable and fixed costs of the business, sales projections and cash flows. In addition, some of the interviewees also mentioned that other general information such as marketing strategy, main suppliers and a brief background of the business and its current position would be of some interest. Therefore, it can be said that having a good business plan that includes financial considerations and projections as well as business strategies is a positive sign for the bankers when assessing loan applications of SMEs clients.

The Purpose of the Loan

Typically, in a loan application the applicant will be asked about the purpose for which the loan is requested. The rationale behind this is that bankers are willing to know if the type as well as the amount of the loan requested suit that purpose or not. In this respect, there was an agreement among the interviewees that the purpose of the loan is an important criterion considered when assessing SMEs loan proposals.

Loans granted by *Bank Al Tanmeya* to its SMEs clients, according to the bankers, are in general for purposes such as developing new products, expansion and modernisation and also for start-ups. The participants stressed that the purpose of the loan is a significant variable in the lending assessment of SMEs clients. Their responses implied that the purpose of the loan must be specified within the loan application. It was further explained that understanding the intended use of the loan helps to understand whether the request of the loan is reasonable, justifiable and therefore acceptable.

It was observed that the bankers are highly concerned about what SMEs borrowers will use the loans for. In other words, they are interested in ensuring that the intended purpose for which the loan is requested will be adhered to. This may also indicate that they are concerned that SMEs may use the loan for other purposes than the ones originally declared in the application. This is actually very true in the Libyan environment. One interviewee commented that:

"*From my experience, it is very common that SMEs borrowers might use the loans granted for other purposes, usually personal purposes".*

It is also, from bankers' point of view, essential to inquire about the purpose of the loan in order to verify whether the requested amount is correct and can be justified for that purpose or not. In this regard, in practice terms, loan officers can also act as advisors assisting SMEs applicants in determining the right amount for which to apply to meet their intended purposes. One interviewee said:

"It is also important to question the applicant regarding the purpose of the loan so we can discuss whether the requested amount is suitable for that purpose. In fact, in some cases clients do not specify the

amount and leave it to the banker's advice and experience".

The Type of Business

When assessing SMEs lending applications, the type of business activity of potential applicants is another criterion considered in the process. According to the bank's lending policy and guidelines, loan applications by SMEs in certain sectors are prioritised. However, according to the interviewees, this does not mean that these firms will receive any preferential lending conditions such as a lower rate of interest or less collateral requirements.

As a state-owned bank and in line with the national economic plans, *Bank Al Tanmeya* prioritizes some business activities in certain sectors when lending to SMEs. Some of the interviewees explained that in general, all sectors would be considered, nevertheless, based on the firm's specific industry or type of activity some loan applications might be given a priority. It was further explained that the policy of the bank encourages targeting specific client types and activities which are deemed to be of long term prospects and in accordance with the national economic and development plans. One senior banker revealed that over the last few years the bank had granted loans to various businesses operating in health and medical services, transportation and constructions based on their specific sectors. He further explained that this policy is not confined on the nature of the business as it also, in some cases, takes the characteristics of the entrepreneur into account. He said:

"Each year we have a certain number of loans allocated to SMEs clients which have to be directed to certain sectors of business or certain types of entrepreneurs. For example, this year (2013) 2000 loans were allocated to target SMEs mainly those of manufacturing nature. Similarly, last year (2012) we were instructed to receive loan applications mainly from the youth (young people aged between 25-40 years) who have a university degree or equivalent".

The discussion with the participants revealed that whilst the type of business activity would be favourably considered when processing SMEs loan applications, it is no more important than other assessment criteria. The participants remarked that they might not be willing to process the loan application if other criteria such as collateral security and convincing business plan are not going to be met. In other words, apart from given the priority there will be no difference in the evaluation process of SMEs loan applications of firms operating or intending to operate in certain business sectors. Therefore, the type of business activity or industry sector, on its own, does not indicate that the loan application would be ultimately approved.

Business Experience

In addition to credit history, the interviewees referred to the trading and business experience of SMEs owner-managers as important. From the bankers' point of view, the success of the business depends largely on the management skills and expertise of the owner-manager. Therefore, in their opinion, experience acquired from prior self-employment, prior employment in the same business and even from prior business failures could be a good indication of the capability of running a viable business which, in turn, may indicate an ability to generate profit and repay the loan.

One of the bankers commented:

"Business experience of the applicant is really important. For me, I would prefer to deal with people who know what they are going to do and are aware of the environment of their business and any challenges involved. Such people with experiences are more likely to experience future growth and success which is good for the bank in the long run".

According to some of the interviewees, while it is realistic and reasonable to expect that experienced owner-managers have generally more ability to set and present good business plans, however, in practice that is not usually the case. These interviewees explained that in many cases SMEs owner-managers applicants with business experience think that they can just rely on their experience and knowledge of the business to have their applications approved. As such, they think that they do not need to prepare business plans which are very critical to proceed with the loan applications. For this particular reason, it was found that in terms of practice bankers at *Bank Al Tanmeya* seem to attach less importance to the business experience of SMEs owner-managers when assessing their loan applications if it is introduced by SMEs applicants as a substitute to business plans.

The Applicant's Character

The respondents were asked whether the characteristics of the applicants (SMEs owner-managers) have any impact on the process of loan applications. Here the discussion was directed towards some personal attributes of the applicant that are not directly related to his/her business and management knowledge and experience which were discussed earlier. Personality attributes such as integrity, honesty, and morality were the subject of the inquiry.
The interviewees referred to this as "assessment of character". According to them character assessment is usually performed to form an idea about the willingness of borrowers to repay the loan. Interestingly, there was some variability between the interviewed bankers on the importance of this type of information. Specifically, two different views were noted amongst the responses. The majority of the bankers regarded some personality characteristics of the applicant such as trustworthiness, reputation, honesty and integrity as of particular important to process and recommend the application for lending. Such characteristics, according to this group of bankers, have the ability to create a trust between them and the applicants and thus facilitate their credit decisions. In addition, these bankers explained that as a part of the process of SMEs loan applications, the bank does gather information about the applicants' ethics and reputation. Some characteristics can be also observed during the interviews with the clients. This can be seen as an indication of how important is this type of information for loan officers to make decisions on SMEs loan applications. In the words of one banker:

"We are meant to deal with different people from different sectors of the society…. I can comfortably say it is always easier to process with the applications of those who are honest and transparent. This kind of clients will always have my support".

On the other hand, however, some respondents indicated that this type of information is less important and seems to be rather informal. In their point of view personal attributes of SMEs borrowers might be of some importance but should not influence their assessment of loan applications. They appeared to be more concerned with other types of personal information. They believe that when it comes to the borrowers themselves other information relates to the clients' credit history and business knowledge is far more important. One banker of this view commented:

"When judging SMEs loan applicants, I can see the need for the personal characteristics of the manager to be taken into account, however, in my opinion, more consideration and attention should be given to business-related qualities such as their experience, management skills and knowledge of the business that can reflect how healthy the business is".

Nevertheless, all the respondents stated that personality characteristics of SMEs borrowers in themselves generally are not sufficient enough to have a real impact on the final decision on the loan application.

From the analysis and discussions above regarding the eligibility criteria for SMEs loans, it can be concluded that SMEs' business proposals and loan applications are considered case by case. Both existing SMEs clients and prospective customers go through the same credit process and the same eligibility criteria apply in both cases. It has been realized that the bankers do not clearly assign weight or priority to each factor/criteria, however, the discussion revealed that some criteria are more important and can be considered as "top criteria" such as security/collateral and good business plans. Profitability is also a key factor. Based on discussions with the bankers, the typical criteria for assessing SMEs loan applications by *Bank Al Tanmeya* are highlighted below:

- The profitability of the business.
- The availability of collateral.
- The applicant's credit history.
- Financial statements.
- The provision of a good business plan.

The intended purpose of the loan.
The type of the business activity.
The applicant's business experience.
The applicant's character.

All these parts together create an overall picture of the business which lies as a base for the credit decision for SMEs clients.

It was also among the aim of this study to investigate the main reasons for declining SMEs loan applications. Specifically, the bankers were asked, based on their experience, to identify the most frequent reasons for SMEs proposals being rejected.

Not surprisingly, the bankers made frequent reference to collateral-related reasons as common factors. They mentioned that they expect SMEs applicants to be able to provide collateral to secure the requested loans. Subsequently, the failure to provide or prepare a suitable security simply means that the loan applications are to be declined. The bankers mentioned that to take the funding application further they expect suitable collateral preferably in the form of fixed assets or other assets of tangible nature to be provided. These collateral-related reasons, according to the interviewees, range from not adequate collateral and collateral of insufficient quality to the inability to provide any.

Another factor that leads to the rejection of the SMEs loan applications is the type of the business activity. It was emphasised that the bankers are not keen to finance certain businesses or industries because of their high risk. Moreover, from the bankers' perspective if the result of the evaluation of the ability of the business to generate income, based on the bankers' experience of the business activity, is not satisfactory the application will be rejected. One of the bankers explained why some applicants could be rejected just because of the business to which they belong. He indicated that some people establish some kind of business just to follow the fashion because other people are doing the same. He added, this trend has become known to the bank and, as a result, certain businesses are no longer attractive because their market is simply "saturated or overloaded".

In addition, poor indication of the capacity of the potential borrower is another common factor for rejecting SMEs loan applications. During the evaluation process, based on information from the business plan, the feasibility study and the financial statements (if provided), if the loan officers are not satisfied with the performance of the business and the capacity of the applicant to repay the loan, the application will not be considered. Likewise, it was found that in many cases poor repayment records with other lenders can lead to reject the application.

Other common reasons that cause rejection of SMEs loan applications included lack of expertise, size of the requested loan, bad or incomplete business plan, previous banking history and low level of profits. Also, insufficient business case and proposals inconsistent with the bank's credit policy were among the reasons mentioned.

It can be concluded from the respondents' answers that various reasons result in the rejection of SMEs loan applications. However, in general, they all can be attributed to applications that are not robust enough to meet the lending criteria. It also was found that one single factor, on its own, is enough to be the reason for the rejection. It is lack of collateral security which was found the most frequent. Other important factors include, but not limited to, weaknesses in business plan, concerns about the loan repayment, bankers do not see the viability of business ventures and the proposal being against the bank's policy.

Conclusion

Gaining an insight into how bankers evaluate and assess SMEs loan applications is an important link to increase SMEs chance of receiving credit and consequently boost their contributions to the economy. Yet, there has been limited research done into understanding bankers' credit decision to this sector especially in the context of developing countries. Thus, this paper sought to address this deficiency by investigating the criteria used by loan officers when assessing SMEs loan propositions in Libya. The results are based on interviews conducted with senior bankers at *Bank Al Tanmeya,* a leading bank in serving SMEs in Libya*.*

In general, the fundamentals of profitability, security and suitability are applied in assessing SMEs' loan proposals. In particular, most importance is attached to the ability to provide collateral and convincing business plans alongside the ability of generating profits. Collateral is perceived not just as insurance for the bank but also as an indication of the commitment of the borrower to repay. Other criteria found to be important include the type of the business activity, the applicants' credit history and their business experience. Contrary to the general trend in the literature, not much emphasis is placed on the information in SMEs financial statements as they are difficult to obtain and, if any, they are perceived as dated and unreliable. Usually, failing in meeting these criteria leads the applications to be rejected. It is lack of collateral security which was found the most frequent reason for rejection.

By providing a case study on the SMEs lending in a developing country, the findings of this study contribute to a better understanding of this topic especially in the developing countries' context where the existing literature has so far been found to be lacking. Furthermore, the current study provides information on the criteria mapping SMEs access to bank loans from the point of view of bankers. Such a closer insight has the potential to increase SMEs owners' understanding of the logic of the lending officers' decision process and, in turn, enhance the probability of their loan applications to be successful. Additionally, the results might be beneficial in improving credit practices regarding SMEs lending for banks and other financial services' providers involved in serving this market.

This study was confined to a single bank, thus one should be careful about generalizing its findings. It would be useful to replicate the study in other banks within Libya and compare the results. This offers a line of future research. Moreover, further research could consider studying the impact of trust characteristics and the bankers-SME owner-managers relationships and the bank organisational structure on SMEs credit decisions. This could provide useful insights on the possibility to adopt relationship lending approach to lend to SMEs which could mitigate the problem of SMEs lack of collateral.

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