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Guidelines and criteria used by formal financial institutions to assess credit applications from small and medium enterprises in South Africa

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Background: The involvement of formal financial institutions (FFIs) in financing small and medium enterprises (SMEs) is and always has been a fundamental issue of concern amongst policymakers and practitioners in developing countries such as South Africa, which experience very low or no economic growth.

Aim: This study analysed the guidelines and criteria used by FFIs to assess credit applications from SMEs.

Setting: This study investigated the guidelines and criteria instituted by the head office of FFIs when assessing and evaluating credit applications from SMEs in Johannesburg, South Africa.

Methods: This study used an interpretivistic research paradigm to achieve the research objectives. Semi-structured in-depth interviews were used to collect data from participants and analysed using the Terre Blanche, Durrheim and Kelly five-step process of content analysis.

Results: The findings revealed that assessing the amount of risk, scrutinising financial records, performing thorough background checks and requesting all relevant documentation constitute ways used by FFIs to measure the amount of risk associated with a particular credit application. Additionally, collateral, audited financial statements, annual business turnover, relationship with the bank and credit profile of the owners and/or business are the most important criteria used by FFIs when assessing credit applications.

Conclusion: This study provides insights into the guidelines used by FFIs in assessing credit applications and the criteria used by FFIs when assessing and granting credit. This study revealed that some FFIs do not finance foreign-owned businesses as part of their institutional policy.

Keywords: credit assessment; supply-side perspective; formal financial institutions; developing economies; access to credit; SMEs.

Introduction

Small and medium enterprises (SMEs) dominate both developed and developing economies and are globally recognised as the prime vehicle for economic development (Organisation of Economic Cooperation and Development [OECD] 2017). They are a major source of employment (World Bank 2019), revenue generation (OECD 2017), innovation (Furawo & Scheepers 2018) and technological advancement (Saunila 2016). Therefore, governments throughout the world are paying much attention to the development of SMEs to promote economic growth. For instance, in the United States of America, SMEs are the source of about one-third of both domestic employment and sales value (OECD 2017). In the European Union, SMEs account for about half of the total value added and two-thirds of the domestic workforce (European Commission 2019; Katua 2014).

In most developing economies, SMEs contribute more than 50% of the total employment and Gross Domestic Product (GDP). For instance, SMEs in Ghana contribute 70% of GDP and 85% of all private sector employment (Quaye et al. 2014). In Kenya, SMEs contribute 53% of GDP and 60% of the total employment (Peprah, Mensah & Akosah 2016), and approximately 51% of GDP and 60% of the total employment in Nigeria (Onakoya, Fasanya & Abdulrahman 2013). In China, SMEs contribute about 60% of GDP, and generate more than 82% of the total employment (Motilewa, Ogbary & Aka 2015).

Since the advent of the economic reform programmes in 1996, there has been a remarkable change in the South African government's attitude towards the SME sector. This sector has been identified by the government as a priority for increasing jobs so as to resolve the high unemployment rate, which is currently estimated at 29.1% of the economically active population (Statistics South Africa 2019). In South Africa, SMEs contribute 40% of GDP compared to the 1% of large businesses that contribute about 60% of GDP and 46% of total employment (National Planning Commission [NPC]) 2015). Additionally, the NPC (2015) maintains that the contributions of SMEs to the socioeconomic development of South Africa can play an important role in achieving Vision 2030 of the National Development Plan, which is to reduce the unemployment rate to less than 10%.

However, despite the noted contribution of SMEs in both developed and developing economies, SMEs in South Africa have one of the lowest established business rates and the highest failure rate of all the countries sampled by the Global Entrepreneurship Monitor (GEM) (Daniels, Herrington & Kew 2017) report on entrepreneurship. This report revealed a 26% decline in South Africa's established business rate since 2014, stating that of all the economies that participated in GEM (Daniels et al. 2017), South Africa ranked 61st out of 65 economies. In addition, the report noted that only 25% of SMEs in South Africa survive after the first 5 years of operation (implying a failure rate of 75%).

Consistently, contemporary literature reveals that the non-availability and non-accessibility of formal sector financing is the main constraint affecting SMEs in developing countries such as South Africa (Daniels et al. 2017; Herrington & Kew 2014; OECD 2017; World Bank 2019). In addition, GEM (Daniels et al. 2017) and OECD (2017) highlighted that only 25% of SMEs in South Africa have access to finance from formal financial institutions (FFIs). Consistent with these findings, the Small Enterprise Development Agency (SEDA) (2017) maintains that the majority of credit applications (about 75%) by SMEs to FFIs are rejected. From the noted statistics, the unanswered question is 'why such a high credit rejection rate'. Finance being the life-blood of any enterprise, the World Investment Report (2017) and World Bank (2019) advocate that scholars do more research to improve SMEs' access to credit from FFIs. Whilst research (Fatoki 2014; Herrington & Kew 2014; Peprah et al. 2016) on SMEs' financing in developing economies like South Africa focused on the challenges and factors affecting SMEs' access to credit from FFIs, Chowdhury and Alam (2017) warned that the stringent credit assessment guidelines and criteria put in place by FFIs might be the brain behind the high credit rejection rate. Research on the credit assessment guidelines and criteria from a supply-side perspective in developing economies, such as South Africa, is lacking and thus necessary.

In South Africa, because the majority of SME owners raise their start-up and running capital from personal or family savings, which are often inadequate for survival and growth, SMEs have to rely on financial support from FFIs (Akinboade 2015; Fatoki 2014; Herrington & Kew 2014). Contemporary literature reveals that no single study in South Africa has investigated the credit assessment guidelines used by FFIs in assessing credit applications received from SMEs or the criteria used by FFIs in assessing and granting credit to SMEs (Chowdhury & Alam 2017; World Bank 2019; World Investment Report 2017). Therefore, the aim of this study is to analyse the guidelines and criteria used by FFIs in assessing and granting credit to SMEs in Johannesburg, South Africa. From this research aim, the research objectives for this study are to investigate the:

- guidelines used by FFIs in accessing credit applications from SMEs in Johannesburg, South Africa.
- criteria used by FFIs in assessing and granting credit to SMEs in Johannesburg, South Africa.

Literature review

According to Daniels et al. (2017), OECD (2017) and the World Bank (2019), the inability of SMEs to access formal sector finance is primarily a supply-side problem. Supply side refers to providers or suppliers of credit (lenders), which, in this case, are the FFIs. From the supply-side perspective, various scholars (Adzido & Azila-Gbettor 2014; Ramlee & Berma 2013; Richard & Mori 2012) argue that some of the reasons why FFIs do not lend to SMEs in developing nations are cost-effectiveness of credits to SMEs, imperfections involved in SME lending, opaqueness of borrowers, high transaction costs, information economics arising from imperfections involved in SME lending and lending technologies and guidelines used by FFIs to assess credit applications.

Theoretical arguments advanced by Arena (2011) and La Rocca, La Rocca and Cariola (2011) reveal that information asymmetry, resulting from imperfect market conditions leading to credit rationing, low levels of accountability for credits, poor bookkeeping, lack of credible collateral, lack of transparency and market risks, are some of the reasons why FFIs adopt credit rationing behaviour. In addition, La Rocca et al. (2011) state that most SMEs are not sufficiently financially stable to access credit from FFIs, as SMEs cannot afford market interest rates.

Whilst Chowdhury and Alam (2017) argue that inadequate financing of SMEs in developing nations is influenced mainly by supply-side credit guidelines and criteria, SMEs contend that they do not know why their credit applications are rejected, because FFIs seldom provide feedback (Ramlee & Berma 2013). Akinboade (2015) and Fatoki (2014) find that FFIs in developing nations seem to be uninterested in financing SMEs; this phenomenon is referred to as the 'discrimination hypothesis'.

Makomeke, Makomeke and Chitura (2016) explain that the discrimination hypothesis stems from the credit guidelines and criteria used by FFIs in assessing and evaluating credit applications from SMEs. Additionally, Makomeke et al. (2016)

point out that FFIs over the years have experienced problems with non-performing credit as a result of weak credit analysis, resulting in the high rejection rate of applications for credit. With such high rejection rates, most SME owners are confronted with questions such as: 'What are FFIs looking for from me and my business?' Various authors (Liang et al. 2017; Makomeke et al. 2016) argue that most FFIs have set up standard risk assessment guidelines and evaluation criteria in screening credit applications, which is a major hindrance to most SMEs.

The primary purpose of any credit assessment and evaluation procedure is to measure or ascertain the amount of risk involved and to help FFIs make good credit decisions. According to Liang et al. (2017) and Chowdhury and Alam (2017), most FFIs follow certain principles in evaluating credit applications and making credit decisions. These principles are summarised in the 'five Cs of credit' (character, capacity, capital, conditions and collateral) which have been applied as a rule of thumb in the lending market. Chowdhury and Alam (2017) state that no single C is more important than any other C, and all five Cs together help to form a complete picture of the project and client. The principle of the five Cs of credit is to establish the creditworthiness of a borrower. The concept, if correctly applied, seeks to evaluate the key criteria of repayment ability, by analysing the stream of cash flows, the character of financial discipline, the financial health of the borrower and other qualitative measures.

Fatoki (2014) categorises the five Cs of credit evaluation into objective and subjective criteria. Objective criteria are those that could be measured in terms of ratios and values (such as capital and collateral as measured by owner's cash contribution and business plan). Subjective criteria (such as the usefulness of the business plan and whether the owner understands the content of the business plan, competent management structure, feasibility of the business in terms of competition and viability) are those where the opinion of the credit manager (making credit decisions for FFIs) is of prime importance in making the decision.

Irrespective of the credit evaluation criteria (objective or subjective), present-day credit guidelines, assessment and evaluation criteria are a combination of the traditional method (the five Cs) and the modern method of risk management. Technological advances have enabled financial engineers to construct new methods of model building and analysis for credit risk measurement. Factors such as increase in competition in the credit market, which necessitate the development of methods that are faster, more accurate and more cost-effective, have also contributed significantly to the recent surge in technology-based analysis methods. Increasing consumer expectations have led more customers to expect a more efficient credit approval from FFIs. In circumstances where certain FFIs have made credit access tardy and hardy, customers have shifted their attention to other institutions. Confidence and loyalty are highly questioned amongst consumers. As a result of the increase in bankruptcies and global competition in recent times, FFIs are calling on their business and credit managers to be more prudent in adhering to the credit guidelines and criteria in assessing and evaluating credit.

Research design, approach and method

In order to address the objectives of this study, a qualitative research design located within the interpretivistic research paradigm, grounded in the epistemological tradition of constructivism and pragmatism, was used (Collis & Hussey 2014). As such, human subjectivity is part of the research process, which means that the researcher applied a self-reflexive attitude to achieve qualitative, in-depth interpretations of the text of lived experiences (Bambale 2014).

This research focused on the eight largest FFIs in South Africa, responsible for about 91% of all assets and about 85% of all liabilities in the commercial banking sector (Banking Association of South Africa 2018), which employ about 106 credit and business managers in the Gauteng province. Purposive sampling was used in selecting the participants from the eight selected FFIs in Gauteng, often referred to as 'the head office banks'. The head office banks have all the policies and guideline documents in place to guide the lending decisions of credit and business managers at branch level. The head office banks also have more knowledge and experience in making lending decisions. The purposive sampling focused on credit and business managers at head office level, because interviewing these managers would yield more insights than interviews with branch office managers. Taking into consideration regulations and guidelines governing credit lending in each FFI, interviewing more than one credit manager and one business manager from a single institution would normally lead to data saturation. Therefore, a credit manager and a business manager were interviewed from each institution, giving a total of eight credit managers and eight business managers who voluntarily accepted being interviewed.

With respect to research ethical clearance, permission was obtained from the selected institutions and consent form was signed by each participant. The participants were assured of anonymity, confidentiality and the option to withdraw from participating at any time. Of the participants, seven (44%) were women (three credit managers and four business managers), whilst nine (56%) were men (five credit managers and four business managers). All were South Africans.

Data collection

Face-to-face in-depth interviews (conducted in English) that ranged between 45 and 60 min, were used to collect data for this research by the researcher between May and August 2019. The interview guide was divided into four sections. The first section was the demographical characteristics of participants. The second and third sections focused, respectively, on the guidelines and the criteria used by FFIs in assessing credit applications from SMEs, and the fourth section on improving access to credit by SMEs. Examples of the interview questions follow:

- 'Given your experience as a credit/business manager over the years, what are the guidelines used by the institution in assessing credit applications?'
- 'With respect to the major investment areas you have highlighted, what decision-making criteria do you consider when lending to start-up, established and expanding SMEs?'
- 'Given the lending criteria put in place by your institution, to what extent do SMEs comply with these criteria?'

The collected qualitative data were transcribed and then stored according to the ethical guidelines. Data were also resubmitted to the participants to enhance credibility and legitimacy of the findings.

Data analysis

The five-step process of content analysis described by Terre Blanche, Durrheim and Kelly (2006), namely familiarisation and immersion, inducing themes, coding, elaboration and, finally, interpretation and checking, was used to analyse the qualitative data.

Qualitative research criteria and limitations

The qualitative data analysis was evaluated against the qualitative 'quality research criteria' (Collis & Hussey 2014) of confirmability (objectivity), transferability (external validity), credibility (internal validity) and dependability (reliability). A transparent description of the analysis, supported by a sound research design and data analysis and a detailed description of the research process, contributed to the quality of the research findings (Collis & Hussey 2014). The researcher's immense knowledge of the subject and the participants' expertise also contributed to the credibility and dependability of the research findings. With regard to transferability of the research findings, this study was conducted at the head offices of the eight selected FFIs located in Gauteng. Consequently, the findings are not generalisable to other FFIs operating in South Africa. Nevertheless, the findings could be useful to other FFIs which were not part of this research.

Research findings

The biographical characteristics shown in Table 1 list the participants' gender, age range, ethnic group, current position (CP), duration of current position (DCP), previous position (PP), duration of previous position (DPP), highest qualification (HQ) and previous employer (PE). Interviews were conducted with eight credit managers (C_1–C_8) and eight business managers (M_1–M_8), as shown in Table 1.

The research findings, aligned with addressing the research questions stated above, are presented in the following sections.

Assessment of credit applications from small and medium enterprises by the formal financial sector

Table 2 provides a tabular summary of the perspectives of participants on the assessment guidelines used by FFIs to assess credit applications from SMEs.

In Table 2, the participants are listed in the first column and the frequency of citations of a particular factor (second column) is given in the third column. This means that, for example, in terms of risk assessment, whilst all the credit and business managers regarded this factor as being important, the importance was further enhanced by the frequency (n = 16) of mention by these participants. The level of importance of each factor is thus determined by the frequency of mention rather than the number of participants.

Risk assessment (as shown in Table 2) in a credit application is considered the most critical aspect (n = 16) which FFIs have to deal with. The credit risk level of every enterprise is often evaluated by the institution's internal credit scoring models.

TABLE 1: Biographical data of participants.

Code	Gender	Age range (years)	Ethnic group	CP	DCP (years)	PP	DPP (years)	HQ	PE
C_1	Male	35–40	Black	CM	5	RM	7	Degree	Another employer
C_2	Female	30–34	Black	CM	3	RM	6	Diploma	Same employer
C_3	Male	41–45	White	CM	7	RM	4	Degree	Same employer
C_4	Male	35–40	Black	CM	6	CA	5	Degree	Another employer
C_5	Female	35–40	Black	CM	6	CM	7	Advanced diploma	Same employer
C_6	Male	41–45	Black	CM	4	CM	7	Degree	Same employer
C_7	Female	35–40	Black	CM	6	BM	8	Degree	Another employer
C_8	Male	35–40	Black	CM	6	CM	4	Degree	Same employer
M_1	Female	35–40	Black	BM	7	CA	5	Degree	Another employer
M_2	Female	35–40	White	BM	4	RM	7	Degree	Same employer
M_3	Female	30–34	Indian	BM	5	RM	6	Postgraduate degree	Same employer
M_4	Male	50–55	White	BM	11	BM	5	Matric (NSC)	Same employer
M_5	Male	41–45	White	BM	5	BM	5	Degree	Same employer
M_6	Female	41–45	Black	BM	8	RM	5	Advanced diploma	Same employer
M_7	Male	35–40	Black	BM	6	BM	4	Degree	Same employer
M_8	Male	35–40	Black	BM	4	CA	6	Degree	Another employer

Source: Researcher's own compilation based on data collected

CP, current position; DCP, duration of current position; PP, previous position; DPP, duration of previous position; HQ, highest qualification; PE, previous employer; CM, credit manager; BM, business manager; CA, credit analyst; RM, relationship manager; NSC, National Senior Certificate.

TABLE 2: Participants' perspectives on assessment guidelines used by the formal financial institutions to grant credit.

Participants	Assessment guidelines	Frequency (n)
C_1; C_2; C_3; C_4; C_5; C_6; C_7; C_8; M_1; M_2; M_3; M_4; M_5; M_6; M_7; M_8	Risk assessment	16
C_1; C_2; C_3; C_4; C_5; C_6; C_7; C_8; M_1; M_2; M_3; M_4; M_5; M_8	Scrutiny of financial records	14
C_1; C_3; C_4; C_6; C_7; C_8; M_1; M_3; M_4; M_7	Proper documentation	10
C_3; C_4; C_5; C_6; C_7; C_8; M_3; M_4; M_6; M_7	Background checks	10

Credit scoring is a technique that assists FFIs to determine if the enterprise is creditworthy. Hasan (2016) states that assessing the risk of a business is an important aspect in determining access to finance from FFIs. Considering the fact that FFIs are out to make profit, it is important for them to carefully assess the profile of SMEs applying for credit, as indicated by participant C_3:

> 'We use financial information of the business, debt history of the business, payment history of the business and personal information, like checking the ITC records of the owners and your track records with other financial institutions and so forth. All these will help us to evaluate the risk level of the business and the owners. We are tired of losing millions in the form of bad debts because the business is nowhere to be found anymore after collecting our money.'

It also emerged from the interviews that FFIs sometimes work with small businesses to enhance their cash flow as a measure to reduce the risk of the credit application. This view is contrary to literature asserting that FFIs are not interested in lending to SMEs – as noted by Akinboade (2015) and Fatoki (2014) – as indicated in the excerpt by one of the participants (M_8):

> 'Most small businesses do not understand how to work with a working capital. So that is the biggest thing I focus on to try to help them manage their cash flow effectively, investing in assets the proper way if I can help finance the different assets, the proper way.'

A thorough scrutiny of the financial records of SMEs is the second most important (n = 14) aspect usually considered by FFIs when scrutinising an application for credit. Participants revealed that 'financial statement lending' focuses more on evaluating information from the financial statements of SMEs. Information obtained from financial statements acts as an indicator of borrower's future prospects and ability to service the credits, as participant M_5 explained:

> 'You look at their financials and you can just grant the funding looking at their financial records because they are already in the business. So, we will just refer to their financials, how they have been doing in the past years and what is the funding for, you know? Is it to really expand the business? Then, you need to give us the proof that you are really expanding the business or is it just to maintain the current one maybe, or you just need capital for running the expenses of the business?'

Another participant (C_8) concurred with M_5 and maintained that:

> 'The audited financials of the business and the owners are the most important. If not available, then a management account; if not available, then bank statements. I think they are good enough, even though a lot of credit managers do not really like them. Bank statements are also evidence to show that the client can pay back the loan or not.'

Proper business registration documentation (n = 10) is also important in securing credit from FFIs as one of the participants (M_5) pointed out:

> 'Mine is to collect information and do a motivation. For me to do those things, I will need a business plan. I will need your cash flow projection projected for twelve months. I will also need your personal balance sheet and income statement. I will also need your ID, company registration documents and then, once I have that information, I can try and see is it possible for us to put in credit information. I will obviously look at your credit record whether you can be able to do that application.'

Finally, background checks (n = 10) are performed to establish the trustworthiness of SME owners. They generally involve checking for criminal records or whether any individuals involved in the business have been sequestrated in the past. Participant C_2 indicated the following:

> 'We use credit checks, the ITC and then also, we will require if maybe the client, how many directors are there and then we require each and every ID of the director of the company and then we also check the company on ITC. We also check all the individuals involved in the company through ITC. Remember, sometimes, if let us say we cannot be lending money to people who were maybe sequestrated or maybe people who had criminal offence, and then if maybe we cannot also be providing money to people who cannot look after their finances.'

Another participant (M_1) stated:

> 'You should have books, your bookkeeping, if you do not have an account. You should have records, you should have invoices, we would actually look at such things. So, we make sure that if we are lending to this person, we have an idea of who they are and where they want to be because any business would not lend to a company that is not profitable.'

However, for businesses owned by immigrants, it is particularly difficult to conduct background checks because of the difficulties involved in verifying information from outside the country. For such reasons, some FFIs do not give credit to immigrant-owned businesses. World Bank (2019) noted that the lack of trust in foreigner-owned businesses makes financing more complicated and difficult, even though immigrants are requested to pledge a collateral that must be of more value than the credit. Of the few that do grant credit to immigrant-owned businesses, participant M_6 noted that:

> 'When it comes to immigrants, what we normally do is check if their passport is up-to-date, is not expiring and then also, we look if they have working permits into South Africa and a first class collateral to support the credit application. Remember, when it comes to ITC, it goes hand in hand with South Africans and then also it is really difficult dealing with immigrant SMEs because there is lot of fraud happening.'

Criteria used by formal financial institutions in assessing and granting credit to small and medium enterprises

Table 3 provides a tabular summary of the perspectives of participants on the criteria used by FFIs in assessing and granting credit to SMEs.

As shown in Table 3, the ability and willingness to offer collateral (*n* = 32) as a security is the most important criterion considered by FFIs when considering granting credit to SMEs. Pledging a collateral signals the confidence of owners or managers of SMEs about the likelihood of the success of a business. The participants indicated that FFIs usually consider collateral in the form of an investment account, land and/or property, investment policy, surety and contract agreement, as affirmed by participant C_4:

> 'Since I started working with this bank, I can say almost all the credit applications that is backed by a valuable collateral has been approved. When I say valuable collateral, I mean collateral that is valuable to the amount of the credit the customer is asking from us. So, we accept collateral like a property (a house or productive land infrastructure) or an investment account opened with us. We also accept life policy but we must do a serious background check to see that the customer has not default payment of his life insurance in the past and also to know the condition under which the insurance is not valid.'

From this excerpt, it can be deduced that holding a collateral is a way of protecting the institution's interest as the borrower (SME) will be forced to pay the credit. The audited financial statements (*n* = 26) are the second most important criterion considered by FFIs when assessing credit because they reveal information regarding the financial performance of the business, as one of the participants (C_3) pointed out:

> 'Basically, if a client comes to you, they would give us the amount they want us to lend to them or that they want to apply for. So, the main process or the first thing that we basically ask for is their latest audited financials. So, the business has to be trading for two years or more, at least, have sound financials. But if the business is a new business that is less than two years, we would need the business audited financials for six months before we can make a decision.'

TABLE 3: Perspective of participants on the criteria used by formal financial institutions in assessing and granting credit to small and medium enterprises.

Participants	Criteria used in assessing and granting credit	Frequencies (*n*)
C_1; C_2; C_3; C_4; C_5; C_6; C_7; C_8; M_1; M_2; M_3; M_4; M_5; M_6; M_7; M_8	Collateral	32
C_1; C_2; C_4; C_5; C_7; C_8; M_1; M_2; M_4; M_5; M_7; M_8	Audited financial statements	26
C_1; C_2; C_3; C_5; C_6; C_8; M_1; M_2; M_3; M_5; M_6; M_8	Annual business turnover	24
C_1; C_4; C_6; C_7; C_8; M_1; M_4; M_6; M_7; M_8	Relationship with the bank	22
C_1; C_2; C_5; C_6; C_7; C_8; M_5; M_6; M_7; M_8	Credit profile of owner and/or business	22
C_1; C_2; C_3; C_7; M_1; M_2; M_3; M_7	Equity contribution	18
C_1; C_2; C_3; C_4; C_5; C_6; C_7; C_8; M_1; M_2; M_3; M_4; M_5; M_6; M_7; M_8	Business registration documents	16
C_1; C_2; C_3; C_5; C_6; M_1; M_2; M_3; M_5; M_8	Completed credit application form	16
C_1; C_2; C_4; C_5; C_6; C_7; C_8; M_1; M_2; M_3; M_4; M_5; M_6; M_7	Comprehensive business plan	16
C_1; C_6; C_7; C_8; M_1; M_6; M_7; M_8	Nationality	10
C_1; C_2; C_3; C_7; M_1; M_2; M_3; M_7	Valid ID and/or permit document	10
C_2; C_5; M_1; M_2; M_3; M_5; M_8	Quotation from suppliers	7

Small and medium enterprises with favourable annual business turnover (*n* = 24) are most likely to break even and generate sufficient revenue for the owners. If the business can generate sufficient revenue, then the owner of the business stands a good chance of paying back any debt that the business might incur, as stated by participant M_4:

> 'Most of our lending are systematic as we take into consideration the annual turnover. The annual turnover is very important to us because the annual turnover helps us to determine whether if we give you the loan, you will be able to pay back on time. You know, the annual turnover of your business tells us if your business is doing well or your business is not doing well.'

Small and medium enterprise owners that have a relationship with the bank (*n* = 22) can help to reduce information asymmetry between the two parties and also build trust. Participant C_6 spoke of the importance of such relationships:

> 'If the financials have declined, then, financial restitution would do. Some other lending are based on the relationship that you have with the bank, meaning it is not systematic. It would be a relationship that you have. So your credit or business manager would be able to put in a motivation for your credit application.'

Credit profiles of the SME and its owners (*n* = 22), as the credit history and records may reveal, is used to evaluate the creditworthiness of the owners and the business, as mentioned by participant C_7:

> 'If you have been in the business, let's say for five years, we would look at your personal credit record and your business credit record because obviously, after five years, you would have a credit record. We would look if you will be able to pay your debt on time or if your business in the past failed to pay its debt on time. When we check the credit record of the owners, we want to know if they have not failed to pay their debt in the past. If any of the owners once failed to pay their debt in the past, then we will carefully look at the collateral they have offered for this credit.'

Equity contribution of the owner(s) (*n* = 18) signals that the SME owners are investment-ready and most FFIs are very willing to support such businesses. Participant M_5 explained:

> 'As a business manager, I am very motivated when I see that the owners of the business are investing their personal money in running the business. That tells you that the owners are very serious in running the business and they will do everything to make sure that the business does not fail. Let me tell you this: it is a standard practice that we only give 50% of what the equity of a business is. So, in other words, if you put R50 000, we look at R50 000. However, we have got some instances with the DTI [*Department of Trade and Industry*] that they will also give some guarantee from their side to be able to take it up to 80% … it becomes very difficult to just give out loans when the clients themselves do not have anything to motivate that they are serious in their business.'

Business registration documents (n = 16) are also important as FFIs only give business credit to businesses in the formal sector (businesses registered with Department of Trade and Industry agencies such as SEDA). Completed credit application forms (n = 16) provided by the FFIs help the credit and business managers to evaluate if the credit application meets the minimum credit requirements. A comprehensive business plan (n = 16) will provide insights into the SME owners' ability to articulate a good business plan that meets the requirements of investors such as FFIs, as clarified by participant C_1:

> 'You will find someone who will give you a business plan that is not detailed and you will sit and read this business plan and think, not really understanding what the client wants to do. That one, I have seen it most often and is a major one. Also, the way some others write their business plan, you will see someone also giving you a business plan of about 50 pages which can be scaled down to about 10 pages, which makes it easier for me to read the entire document. But if you give me 50 pages business plan, obviously, I will end up reading only about 10 to 20 pages and not really understand your business plan. So, the issue of writing business plans is a major problem with small business owners. We even advise them to look at our website and they will find a sample of a business plan. They do not listen because they want to give you what they have.'

Nationality (n = 10) and valid identification document (ID) and/or permit document (n = 10) also play a fundamental role for FFIs that grant credit to SMEs, as one of the participants (M_7) noted:

> 'As I explained to you earlier, we do not fund SMEs that are owned by foreign nationals. You must have at least a permanent residence permit for us to even look at your credit application. That is the decision we got from top management when I was promoted to this office.'

For SME owners who want to purchase business asset(s), some FFIs will require quotations from suppliers (n = 7). Formal financial institutions use the quotation to assert the value of the asset(s). Participant C_5 stated:

> 'We usually ask our clients to bring us at least two quotations from different suppliers for things they want to buy. We then use the quotations to compare and affirm the value of the loan they have applied for. Most often, the bank would prefer to choose which supplier to buy from and pay the supplier directly if we approve the loan.'

Ethical considerations

This article followed all ethical standards for carrying out research involving humans, with ethical clearance provided by Rhodes University: MAN 01.03.

Discussion

Based on the findings in the section 'Assessment of credit applications from small and medium enterprises by the formal financial sector', the main guidelines used by FFIs in assessing credit applications from SMEs are risk assessment, scrutiny of financial records, background checks and proper documentation in order of merit. The fact that FFIs do lend to SMEs is an indication that they are willing to accept a certain amount of risk. What they are willing to accept depends on the amount of credit they are willing to provide. Therefore, assessing the amount of risk, scrutinising financial records, performing thorough background checks and requesting all relevant documents constitute ways to measure the amount of risk associated with a particular SME credit application.

First of all, risk assessment in a credit application is associated with the amount of credit requested by the borrower and the criteria put in place by the FFIs. Without any expectation, FFIs assess the riskiness of an application by using the institution credit scoring model to determine if the application is creditworthy. If the risk is tolerable, then financial records of the borrower (SME) will be further scrutinised to confirm whether they are legitimate. If the risk is not tolerable based on the institution's credit scoring model, then the credit application is most often rejected upfront or the applicant is asked to revise the application. This finding confirms that FFIs are risk-averse; however, they admit that investing in SMEs is profitable to their business. The risk-averse attitude of FFIs in South Africa has resulted in credit rationing between large corporations and SMEs. As a result, only 25% of SMEs have access to credit because of the high risk in the SME sector, as is evident from GEM (Daniels et al. 2017). Another research by Weber (2018) points out that FFIs are not interested in lending to particular businesses because of the high-risk profile of the business and its owners.

After scrutinising the financial records (by assessing the present and predicting the future performance in terms of sales and profit margins), a decision can be reached whether the credit application should continue to the next stage. This involves background checks on personal and business levels to ensure that the SME and its owners have not defaulted on paying credit in the past. If there has been any past default in payment, then the credit application will definitely be denied. A situation may arise where the SME or its owners are paying another credit with another bank. Under such circumstances, the bank will do a follow-up with the other bank to find out the state of the payment of the credit before making a decision. If the SME or its owners have been honouring the repayments, then they stand a good chance of obtaining more credit from other banks.

The final stage in the credit assessment process is to validate the credit application by ensuring that all the relevant documents were submitted. Any credit application that reaches this stage has a good chance of being approved, as most credit applications are rejected before reaching this stage. It is at this stage that participants (credit and business managers) write their motivation letter and submit the credit application to the credit committee for further review before approval. In cases where the credit committee rejects the credit application because the risk might be high, the committee might want to reduce the original amount requested by the borrower before approving the credit or, better still, consult the participant who processed the credit application for further deliberation on the outcome of the credit application. These findings are supported by Liang et al. (2017) and Makomeke et al. (2016) who agree that credit assessment and evaluation remain at the heart of the decision-making process, and that FFIs over the years have experienced problems with non-performing credit as a result of weak credit analysis leading to the high credit application rejection rate.

As highlighted in the section 'Criteria used by formal financial institutions in assessing and granting credit to small and medium enterprises', pledged collateral, audited financial statements, annual business turnover, relationship with the bank and credit profile of the business and owners were the most important criteria used by FFIs to provide credit to SMEs. Quartey et al. (2017) note that collateral plays a disciplinary role in the behaviour of the borrower. According to Quartey et al. (2017), holding collateral is attractive to FFIs for two reasons. The first is that willingness to offer collateral signals confidence of the SME owners about the likelihood of success of the project, and second, holding collateral can align the interests of the borrower with those of the lender. In this case, both the adverse selection problem of credit origination, and the moral hazard problem after the credit has been granted are addressed. On the other hand, audited financial statements and annual business turnover are used to analyse the SMEs' present and future performances and ability to service credits (Amadhila & Ikhide 2016).

Formal financial institutions wish to invest in SMEs, provided the owners can contribute a significant portion of the starting capital as stipulated in the *South Africa National Credit Amendment Act 7 of 2019*. This implies that FFIs always want to mitigate the risk of granting credit to SMEs. Therefore, the stringent risk-assessment guidelines and evaluation criteria in screening credit applications is a major hindrance to most SMEs. Equity contribution to a business signals that SME owners are investment-ready. This implies that the greater the owner's contribution to a business, the greater the lender's confidence in the business and the less likely that the owners or managers of the business will make risky investments, thus reducing moral hazard, as supported by Quartey et al. (2017). Business registration documents signal the legality of the business; the completed credit application form provided by FFIs evaluates whether the credit application meets the minimum credit requirements. A comprehensive business plan provides both the financial and business information used by business and credit managers to assess the enterprise's strategies and model to determine the viability and growth prospect of the enterprise. Nationality and valid ID and/or permit documents provide pertinent personal information about the legal status of the applicant in the country. Formal financial institutions use validity of the permit to determine the duration of the credit they are willing to offer to the applicant. Immigrant applicants with criminal records will see their loan application rejected immediately without recourse.

Conclusion and recommendations

This study calls on FFIs to adopt more flexible but rigorous standards, so that more SMEs can access credit from them if they are truly willing to lend to SMEs. In addition, this study further recommends that FFIs develop different lending technologies that combine different sources of information about a borrower, screening and underwriting procedures, structure of a loan contract and monitoring mechanisms so as to improve credit access by SMEs.

Formal financial institutions in South Africa could adopt other screening and risk evaluation approaches such as those developed by the Entrepreneurial Finance Laboratory (hereafter EFL) of the Centre for International Development of Harvard University. The EFL approach uses exclusive psychometric testing (a 30 min – 60 min automated test) that incorporates an SME owners' attitude and outlook, aptitude, business acumen and mentality to measure risk and future entrepreneurial potential. As such, the measure of future entrepreneurial potential using the EFL approach does not depend on business plans, credit history or collateral of SME owners and has very low transaction costs. Using the EFL approach could go a long way to benefit all SME owners (including new and immigrant SME owners) who most often find it very difficult to secure collateralised credit from FFIs. However, proposing the use of the EFL approach in South Africa should not discourage SME owners from investing in assets that will add value to their business, such as buildings (fixed assets), investment accounts and business insurance, and keeping good relationship with FFIs (business and credit managers).

Formal financial institutions could also help improve SMEs' access to credit by providing business services such as workshop to educate SME owners on the credit assessment guidelines and criteria, and how to write an attractive business plan. Creating a special unit with a mandate to assess the business plan and collateral pledged by SME owners would also help increase SMEs' access to credit. Nonetheless, SME owners' ability to invest in collateral assets and belong to professional associations will significantly increase their legitimacy and make credit access from FFIs easier.

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Data availability

Data for this article were extracted from F.T.A.'s PhD thesis. The data that support the findings of this study are available from the corresponding author, F.T.A., upon reasonable request.

Disclaimer

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