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SMALL AND MEDIUM ENTERPRISE (SME) FINANCING: CREDIT EVALUATION METHOD

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INTRODUCTION

The past literature on SME financing has discussed how the owners or managers of the firm preferred or choose sources of financing to finance their business. The preference of the sources of financing would change according to the business age (Hussain et al, 2006; Bhaird and Lucy, 2011), country (Hussain et al, 2006), owner's education (Haileselasie, 2009), or even gender (Kim, 2018). The internal fund or retained earnings is the most preferred sources of fund. Based on the SME Annual Report 2018/19, the external debt financing was ranked number two in sources of financing by Malaysian SME after sources of financing from own cash and retained earnings. The dependencies of SME over the external debt financing in some of the countries including Malaysia to finance their business operation is high. Apart from the commercial banks, there are other institutions such as Development Finance Institutions (DFIs) or agencies under various ministries offering to finance not only to SME but also to micro-businesses. With the abundant offers from the banking system as well as from the government-related agencies to finance the SME, the issue of the limited access to external debt financing should not be the reason hindering SME to grow. The main constraint impeding SME business growth is not difficulties in accessing sufficient financing but it was due to an increase in competition and fluctuations in consumer demand (SME Annual Report, 2018/19).

Insufficient documentation, insufficient cash flow, and unfeasible business plans are the main reasons Malaysia's SME loan applications were rejected (SME Annual Report, 2018/19). Every loan application received by the financial institution will go through some evaluation to determine the bankability and viability of the business. We cannot generalize any loan application without enough collateral would be rejected or any newly formed firm is not bankable. There is a scheme for start-up business; there is a loan from related agencies for borrowers that have inadequate collateral. Complete and sufficient information from both parties is very important as any information asymmetry between the lenders and the borrower may delay the evaluation and approval process (Abe, 2015). Thus, by reducing information asymmetry on both parties, it would widen the SME opportunity access to financing from the banking institution as well as other related agencies. The knowledge of how the loan application is being evaluated would help SME owners or managers to prepare all the relevant documents and information to secure the approval of the loan application.

CREDIT EVALUATION METHOD

A loan application basically will go through a similar credit evaluation process and a depth credit analysis will be conducted on project- based business or highly automated industry, manufacturing, or any industry that needs special assessment based on the bank's current credit policy. Every financial institution or lending agency has its processing tools and approaches.

The most famous credit evaluation methods are 5Cs and CAMPARI. There are also 5Ps, LAPP, and Financial Analysis and Previous Experience (FAPE). Even though every method mentioned here has different dimensions, but all of them have many similarities. Abbadi and Abu Karsh (2013) had summarized the dimension of each method.

Table 1 : Credit Evaluation Dimensions

Method	Dimensions
5C's	Character, Capital, Collateral, Condition, Capacity
CAMPARI	Character, Ability to pay, Margin, Purpose, Amount, Repayment terms, Insurance
5P's	People, Purpose, Payment, Protection, Prospective
LAPP	Liquidity, Activity, Profitability, Potential
FAPE	Liquidity ratios, Profitability ratio, Operation ratios, Debt ratios, Character, Credit Record

Apart from the credit evaluation methods mentioned above, there is another supporting method known as credit rating or credit scoring. This method is used by the financial institutions to evaluate any programmed lending and also used as the auxiliary mechanism to enhance the credit evaluation for any non-programmed loan. The financial institution has its in house credit rating or scoring system. The system builds based on three 3 approaches which namely, parametric approach, artificial intelligence approach, and non-parametric approach (Bai et al. 2018). The quantitative credit risk scoring model would also save time and cost of the financing institutions (Shen et al. 2019). The system mainly used to facilitate the process, hence if there is a problem, it always back to the basic credit evaluation method.

CONCLUSION

Every method has its dimension that addressed how risk can be mitigated by providing useful information to the evaluator and decision-maker. The evaluation process would not solely depend on just one method. It involves a combination of several methods by combining selected dimensions. In processing the business loan application, the financial institution will look at the *background of the borrower* which may come in a various business form such as sole-proprietor, partnership or private limited firm, the *management structure* of the firm where the business experience, level of education and the skill of the owner of the firm including the key personnel of the firm is very important, the *firm's financial indicators*, the *conduct of existing banking facilities* including the current account and personal loan of the owner of the firm, the *repayment capability* by looking at the firm's income, *amount of loan* requested versus proposed, the *prospect of the business*, and also the *legal status* of the potential borrower by doing the credit checking with the relevant authorities.

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