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The U.S Based Banks' Strategies for Providing Loans to Small Businesses

Linda Faye Jolly-Evans[1] & Aditya Upadhyay[2]

[1]Administrator, Amegy Bank, United States of America. Email: Ljollyevans@gmail.com
[2]Doctoral Coach, DERC/Vilas Academy, United States of America. Email: Aditvilas@gmail.com

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ABSTRACT

Between 2007 and 2013, the number of loans banks provided to small and medium-sized enterprises (SMEs) declined. The purpose of this single case study was to explore the strategies that senior bank lending officers used to improve lending to SMEs. The sample size consisted of 4 senior small business lending officers who have in lending for 5 or more year in Houston, Texas. The conceptual framework used was agency theory. Data were collected using semistructured interviews with 4 senior bank lending officers from a bank in the Houston, Texas area. The data analysis included process coding of the data collected from the participants. Member checking and methodological triangulation enhanced the credibility of the findings in this study. Three themes emerged from the data analysis: the barriers and challenges lenders face when lending to business owners, bankers' strategies to overcome challenges in lending to their customers, and lenders' use of relationships and lending experience to provide loans to their customers.

Keywords: *Banking lending standards, Bank loans, Relationship banking, Credit crunch, Corporate governance, Lending, Loans, Small businesses.*

1. Introduction

The loan amounts to SMEs from banks declined by 20% between 2007 and 2013 [1]. There was an unprecedented decline in lending to SMEs after the 2008 economic crisis [4]. The Federal Deposit Insurance Corporation (FDIC) closed more than 100 banks in 2009, and another 397 failed between 2009 and 2011 [2].

By the end of 2011, the FDIC listed 813 banks on the list of financial institutions that had lost their ability to continue extending corporate loans [3]. The meltdown of financial markets produced higher rates of unemployment and a decline in lending to small-medium enterprises [4]. The losses banks incurred during the financial meltdown of subprime mortgages caused concerns about the ability of banks to continue lending to small and medium-sized enterprises (SMEs). The crisis caused a severe recession in the U.S. economy and further decreased demand for credit and loans to small businesses [2].

The financial market fallout led regulators to introduce the Dodd-Frank Act to improve corporate governance in the banking industry [5]. The Dodd-Frank Act was the most significant financial regulation since the Great Depression in the 1930s [5]. The Act contains rules regarding identifying and regulating systemic risk. Lending practices called for stricter lending standards that increase dependence on factors like leverage and the amount of capital for short-term funding [5]. An increase in regulatory oversight on credit availability in small businesses put a damper on lending.

The risk of lending to small businesses is higher than to large companies. Few owners of small businesses have the cash flow, collateral, or credit score to borrow money from banks during a fiscal crisis. Little or no collateral affects new small companies when borrowing from banks [6]. As a result, the tendency to lend to small businesses declined to date as banks discover it is challenging to keep pace with the increase in the cost of lending to borrowers, the risk to capital, higher failure rate, fewer assets collateral, and stringent regulatory policies [7].

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This qualitative single case study aimed to explore strategies senior bank lending officers use to improve lending to SMEs. The central research question is: What strategies do senior bank lending officers use to improve lending to SMEs?

2. Methodology

The researchers used a purposeful sampling method to select participants that have experience in the study phenomenon [12]. The criteria for selecting participants were that they:

- ✓ Belong to a bank located in the Houston area.
- ✓ Have access to key information on leading practices.
- ✓ Are knowledgeable about lending practices to SMEs.
- ✓ Are willing to provide an honest and unbiased response to interview questions.

The study method and design were qualitative multiple case studies. Using the qualitative case study enabled researchers to ask 'how' and 'why 'questions. Moreover, a case study design allowed the researchers to better capture the complexity of the social problem through the interview and documentation methods [8].

Data collection involved assessment techniques incorporating open-ended questions in an interview with participants. The data analysis technique involved Yin’s five steps approach [9]: (a) compiling, (b) disassembling, (c) reassembling, interpreting, and (e) concluding.

3. Results and Discussions

Data sources included semi-structured interviews and reviewing organizational documentation for methodological triangulation. The secondary data consisted of company information on small business lending. Data saturation resulted when data became repetitive, and no additional information emerged during the interviews. Under the umbrellas of agency theory, data analysis resulted in three themes: barriers and challenges for business owners, ease in the lending process, and relationships and lending experience. The themes aligned with the findings in the existing literature.

Theme 1: Barriers and Challenges for Business Owners

The first theme from all four participants' responses was the challenges participants faced in lending to businesses. Among the challenges, lenders assumed risks involved in the lending process for businesses. All participants reported the factors that hinder lending are:

- ✓ The lack of collateral to obtain a loan.
- ✓ The presence of high-interest loans.
- ✓ The existence of a short repayment period for their loans.

When lending officers work with small business owners, they are thorough and seek credentials to minimize risk. The loan application provided by participants emphasized that many SMEs lack collateral they can use when applying for a loan and, if they do have a guarantee, business owners do not know how to use it in the lending process. All participants stated that loan officers requested business owners to show future cash flow for payments when applying for a loan.

According to the participants, lenders need to work with their customers to ensure that they have a strategic plan to repay the loan obligation. Small business owners may not be as experienced as lending officers when identifying avenues to improve the cash flow. Therefore, a bank officer needs to involve SMEs in the lending process to determine possible future cash flow, which may help them make an informed lending decision. Small business owners might have great ideas for their businesses and plan to increase future cash flow, but they find difficulties in convincing banks to get the necessary funding. A business owner needs coaching, preferably from the lending institution, on what they can do to increase the chances of getting a loan approved. During the loan briefing, the bank officer suggested getting a contingency business insurance plan to minimize the future loan repayment risk.

Participants claimed to have insurance that aided them in providing a loan. Participants presented some approved loan applications in which all SME owners provided profit and loss statements, which showed the respective companies spent money on different insurance, such as commercial insurance, general liability insurance, business policy insurance, life insurance, and workers' compensation insurance, and property insurance. A loan officer suggested SME owners get some of these insurances to increase the chance of loan approval. Insurance is expensive and adds to the business, but it gives peace of mind to us, the bank, and the company.

Theme 2: Ease in Lending Process

The second theme relates to bankers' strategies to overcome challenges in providing loans and lending experience. Sometimes, customers are impatient with all the documents that must be completed when requiring a loan. According to the participants, banks were working on requiring less documentation and, in some cases, processing the loan by a retail branch rather than requiring application submission by business banking or commercial relationship managers.

A centralized underwriting group also processes small loans for speed and consistency. Strict regulation is making lending difficult for banks. According to the participant, banks collect more financial information as regulations change and become more involved. Banks work very closely with our borrowers to teach them the importance of regulation and complying with the bank's requirements. The bank is providing the tools that help their customer understand lending practices. If there is an asymmetry of information, the loan officer will request a personal interview with the business owner rather than simply denying the loan.

According to the participant, the loan application information is quantifiable, and it helps the loan officer make a quick subjective judgment on the client's loan eligibility. In hassle-free lending practices, the loan officer counsels small business leaders on how to eliminate business risk, transfer risk to others, and manage at the firm level. Participants said that counseling on how to minimize risk often helps customers to prepare a business plan worth reviewing.

Theme 3: Relationships and Lending Experience

The third theme that emerged from the study was the importance of relationships and lending experience in lending. Relationships and lending experience have an impact on providing loans to SMEs. Banks to devote more time to smaller businesses to support the SMEs and educate SME managers when necessary. A close relationship with the lender bank significantly helps borrowers overcome credit constraints and regulatory issues. The participant stated working very closely with their borrowers about regulatory changes, bank lending policy updates, and complying with the bank's requirements by building a relationship. All participants agreed that banks must create a strong relationship with customers if they want their clients' businesses to grow.

Relationship and lending experience is essential in the lending process. Lenders with less knowledge are encouraged to reach out to more experienced lenders to aid their customers. Participants stated that as regulations change and become more involved, banks have been required to collect more and more financial information. SME managers must ensure the firm complies with all rules and federal regulations or pay fines for non-compliance with regulations. Therefore, lending process could involve detail paperwork as mandated by regulators. The bank needs to work very closely with our borrowers to teach them the importance of complying with the bank's requirements.

All participants agreed that lenders must spend sufficient time to ensure their clients understand the importance of complying with the bank's requirements. All the participants agreed that customers think there are just very many bureaucratic requirements needed to be approved for a loan. Some small business owners are unfamiliar with the Small Business Act and the Small Investment Act; therefore, banks educate clients on these documents. The bank lending officers need to familiarize with the small business act, the small investment act, and bank policy to explain the procedures to customers. The revision of these documents and the officer's ability to explain the information ensure the information meets the customer's need for knowledge.

4. Study Limitations

Participants limited their response to the interview questions on bank policies out of concern for confidentiality. Participants kept some of their business information private to protect their customers and the organizations. The findings from this study warrant additional exploration of strategies to provide lending to industry-specific SMEs in another geographical area. The sample for this study consisted of four SME lending officers. Further study that involves a researcher using a large number of participants and a more comprehensive sampling strategy over an extended period to extract rich data and to generalize the results.

5. Recommendations

Though the study involved banks in the United States, the findings could apply to banks in other countries. The recommendations to banks include:

❖ Banks need to work with their customers to ensure that they have a strategic plan to repay the loan obligation.

❖ Provide coaching, preferably from the lending institution, on what business owners could do to increase the chances of getting a loan approved.

❖ Adopt hassle-free lending practices by minimizing the documentation in the lending process.

❖ If there is an asymmetry of information, the loan officer could request a personal interview with the business owner rather than simply denying the loan.

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❖ Banks must build a strong relationship with customers if they want their clients' businesses to grow.

❖ The bank lending officers need to familiarize themselves with bank regulations of their home country to remain informative in lending practices.

❖ Additional research on leading practices for industry-specific SMEs in foreign countries could fill the gap in the literature.

About authors

Dr. Evan has decades of banking experience. Dr. Adit Upadhyay has worked in a leadership capacity in Fortune 500 companies. He is the author of numerous publications.

Declarations

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The authors declare no competing financial, professional, and personal interests.

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Authors declare that they consented for the publication of this research work.

Authors' Contributions

The first author (Linda Faye Jolly-Evans) collected, analyzed data. The second author (Aditya Upadhyay) provided intellectual contribution in paper drafting and further manuscript analysis for journal publication.

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