

**Published in:** *International Journal of Multidisciplinary Research*. 4(6); 2015; 48-55.

## **Antecedents and Consequences of Risk Perceptions in Lending to Micro, Small and Medium Enterprises**

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### **ABSTRACT**

The Banking Sector has played an important role in the modern economy by providing credit to the weaker segments. One such segment is Micro, Small and Medium Enterprises (MSMEs). It has been found in the literature that MSME sector is facing a major hurdle in access to finance. Credit flow to the sector is not found to be adequate although the sector contributes 45 per cent to total industrial production and 40 per cent to the exports of the country.

The Perceived risk towards MSMEs poses greater challenge for banks in providing finance. This paper is an attempt to identify the antecedents of Perceived Risk among the Bank Managers towards lending to Micro, Small & Medium Sector. The paper depicts the analytical framework based on Institutional Theory which uses three kinds of factors -Regulatory, Normative and Cognitive. The study attempts to arrive at a researchable model for Bank Managers' Risk perception using the factors identified from literature and exploratory study.

#### **Keywords**

Credit to MSMEs, Risk Perceptions, lending to MSMEs.

### **INTRODUCTION**

Micro, Small and Medium Enterprises (MSME) sector has emerged as a highly vibrant and dynamic sector of the Indian economy over the last five decades. MSMEs not only play crucial role in providing large employment opportunities at comparatively lower capital cost than large industries but also help in industrialization of rural & backward areas.

The Indian MSMEs contribute 8% to the Country's GDP thereby creating 100 million jobs through the 46 million units from the rural and the urban areas across the Country. They also contribute to 90% of the total Industrial output and 45% of the Manufacturing output of India and comes out with 6000+ products across the spectrum. MSMEs are credited in contributing to 36% of the Total Value of exports from the Country and the sector has recorded a constant year on year growth of over 10% thereby making this sector as the backbone of Country's economy.

As per the report of Industrial Finance Corporation on Micro, Small and Medium Enterprises (MSME) in November 2012, despite the growth in other avenues of raising resources by the industry, the lack of adequate and timely access to finance has been the biggest challenge for MSME Sector. The statistics compiled in the Fourth Census of MSME sector September 2009 revealed that only 5.18% of the units (both registered and unregistered) had availed finance through institutional sources, 2.05% had finance from non-institutional sources. The majority of units i.e. 92.77% had no finance or depended on self-finance. This could be because of the perceived risk involved in lending to SMEs.

Therefore it is deemed important to identify the different factors leading to the risk perceptions by Bank Managers while lending to MSME sector. The paper uses the analytical framework on Institutional Theory to develop a conceptual model for two Risk constructs, namely, Risk Perception and Risk Assessment.

## OBJECTIVES

The objective of this research is to identify the antecedents of Perceived Risk among the Bank Managers towards lending to Micro, Small & Medium Sector. The study seeks to develop a researchable model for testing antecedents of Risk Perception using the factors identified from literature and exploratory case study.

## METHODOLOGY

This study forms the first stage of the research. Exploratory in-depth interviews with three branch managers were conducted. (See Annexure 1). These resulted in three case studies of banks' lending to MSMEs. These were collated with the literature review in the area to develop a testable model for the second stage of quantitative research.

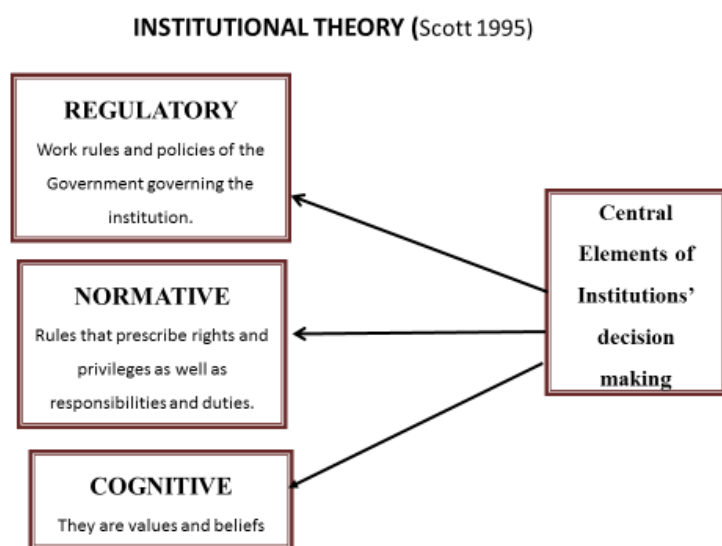
## SAMPLE

Three managers are selected for the in depth interviews for the purpose of building up of case studies. Two from Public Sector banks and one from cooperative sector were taken as sample. Limited sample size was selected in order to come up with detailed case study.

## INSTITUTIONAL THEORY AS THEORITICAL BACKGROUND

The paper depicts the analytical framework based on Institutional Theory which uses three kinds of factors -Regulatory, Normative and Cognitive. Institutional theory attends to the deeper and more resilient aspects of social structure. It considers the processes by which structures, including schemas, rules, norms, and routines, become established as authoritative guidelines for social behavior. (Scott, 1995). Regulative, normative, and cognitive social systems have been identified by theorists as central elements of institutions (Scott, 1995) which are also called as three pillars of Institutional Theory. Regulatory factor focuses different work rules and policies of the Government governing the institution. Normative factors emphasizes on the normative rules that prescribe rights and privileges as well as responsibilities and duties. Normative factors are work norms and habits. Cognitive factors stresses on the values and beliefs of people working in the organization.

Table 1- Framework of Institutional Theory



## LITERATURE REVIEW

### Definitions

#### *Risk*

In literature there are many definitions of risk. In Rational Decision Theory, the concept of risk reflects the variation in the distribution of possible outcomes, their likelihood and their subjective values (Knight 1921).

#### *Risk Perception or Perceived Risk*

Perceived risk has been described in Perceived Risk Theory (PRT) as comprising the subjective perception of two components the

characteristics and severity of a risk (Cox 1967; Cunningham 1967).

## BANK LENDING DECISIONS TOWARDS MSME AND INSTITUTIONAL THEORY

Bank Managers' lending decisions towards MSME Sector depend on the Regulatory, Normative and Cognitive aspects of the banking institution. In Banking various factors identified from the literature are categorized based on the Institutional theory Framework. They are as follows.

### Regulatory Factors

*Loan Assessment Principles*

The basic lending assessment techniques or principles of lending are prescribed by Reserve Bank of India and are consistent across all the different types of banks.

To estimate borrower's creditworthiness banks gather, process and analyze different types of information collected from firms.

These rules and regulations prescribed by Reserve Bank of India have been identified in literature as well as in exploratory case study as integral and static factors across all the types of banks and thus, may not contribute to the Bank Managers' risk perception towards MSME Client.

### *Risk Mitigation*

The process by which an organization introduces specific measures to minimize or eliminate unacceptable risks associated with its operations. Risk mitigating strategies are adopted either to reduce the severity and the probability of risk.

According to Dorfman, 2007, once risks have been identified and assessed, all strategies to manage the risk fall into one or more of these four major categories:

**Risk Avoidance-** Risk Avoidance is not performing an activity that could carry risk. In lending to MSME sector risk avoidance strategy could be adopted by not offering any lending to MSME sector or by keeping the interest rates high for the lending activities which will automatically discourage MSMEs from approaching Banks.

**Risk Reduction-** It is a strategy employing a bit of risk acceptance along with a bit of risk avoidance or an average of both. In lending to MSME sector risk reduction strategy could be adopted by the use of security based lending by banks. (Binks and Ennew, 1996)

**Risk Sharing-** Risk Sharing is a strategy in which the risk is shared with another party to relieve the burden of loss or to achieve the benefit of gain. This strategy is also called Risk Transfer.

**Risk Retention-** Involves accepting the loss or benefit of gain, from a risk when it occurs. Risk retention is a viable strategy for small risks where the cost of insuring against the risk would be greater over time than the total losses sustained.

### **Normative Factors**

#### *Lending Approaches*

In considering whether to advance loans to applicants, banks apply following approaches. Income gearing Approach, Capital gearing Approach, Relationship and Character Lending Approach.

**Income Gearing Approach-** When assessing the loan applications, banks tend to look forward to future earnings potential (of the SMEs), as a source of repayment of the loan and interest. This lending assessment technique is known as income gearing by Berry et al (2003). Berger and Udell (1995) called it financial statement lending,

**Capital Gearing Approach-** Under this approach, credit decisions are principally based on the quality of the assets pledged. (Berger and Udell 1995, Bruns & Fletcher, 2008). In the banking literature this approach is referred to as Security lending approach.

**Character Lending Approach-** In this lending approach, information on the borrower is gathered that can inform banks about the chances of the borrower failing to repay the loan. In this approach, variables such as age of entrepreneur, gender of entrepreneur, age of enterprise, entrepreneur's trading experience and his earlier track record with the bank are given importance. (Bhalla & Kaur 2012).

**Relationship Lending Approach-** In this lending approach, bankers focus their decisions in substantial part on proprietary information about the borrowers through a variety of contacts over time. Mahmood and Rahman (2007); Diamond (1984); Peterson and Rajan (1994) and Berger and Udell (1997) advocated that the relationship banking approach is used to reduce the asymmetries of information when dealing with small businesses.

Exploratory study revealed that Relationship lending is used as an extension to Character lending. A type of lending technique used may vary across the banking organization thereby contributing to Bank Managers' Risk Perception towards Micro Small and Medium Enterprises Client.

### **Cognitive Factors**

#### *Uncertainty Avoidance Attitude (UA)*

Hofstede (1980) defined Uncertainty Avoidance as an extent to which people are "threatened by uncertain or unknown situations" (Hofstede, 1991, p.113). He also argued that Uncertainty Avoidance was not the same as Risk Avoidance. Uncertainty Avoidant people may in fact take a higher risk

option, if it reduces their uncertainty. A Bank Manager scoring high on Uncertainty Avoidance (UA) will first assess the loan proposal to know the details therein. Further, if the proposal is perceived to have high risk but certain, it is accepted.

#### *Risk Avoidance Attitude (RA)*

Decision sciences researchers defined Risk Attitude as “a tendency (for a person) to be attracted or repelled by alternatives that he or she perceives as more risky over alternatives perceived as less risky” (Weber and Bottom, 1989, p.128). Risk avoidance seems to be a relatively stable feature of an individual’s personality (Douglas and Wildavsky, 1982; Johnson and Tversky, 1983) and is not situation specific, but the result of a generalized attitude towards risk.

A person having Higher Risk Avoidance Attitude will have a tendency to perceive a higher risk.

These factors can be categorized as Bank Managers’ Inherent Attitudes which have bearing on Bank Managers’ Risk perceptions towards MSME.

#### **Bank Managers’ Perceived Client Image**

When MSME client walks in the bank initially, this initial interaction of client with the Manager has been identified in exploratory case studies to be playing an integral part in forming Manager’s Risk Perception. Upon interaction with Bank Managers’, it was identified that before the submission of the papers, the manager interacts with the clients in details and tries to know more about the project and the person as well. This initial interaction with the client helps the manager to perceive clients’ Involvement, Attachment and Commitment towards his project.

#### *Involvement*

Involvement is referred to as perceived personal relevance (Zaichkowsky, 1985) or the perceived value of a ‘goal-object’ that manifests as an interest in that goal-object (Mittal and Lee, 1989). Previous research on involvement in the consumer behaviour literature has shown that this goal-object can be a product itself or a purchase decision. In the context of lending in the bank, the Involvement is the client’s perceived value of an idea which itself is an interest in his own proposal.

#### *Commitment*

Commitment has been defined as "an enduring desire to maintain a valued relationship" (Moorman, Zaltman, and Deshpande 1992). Thus, Commitment underlies an ongoing process of continuing and maintaining a valued and important relationship that has been created by trust. As mentioned in the literature, this interaction is used to signal borrowers' commitments to perceive the success of business

ventures because the owners are unlikely to undertake riskier projects or to reduce their efforts. (Besankor and Thakor, 1987)

#### *Attachment*

Two related theoretical areas in which Attachment concept has been discussed are social psychology in the late 1940s (e.g. Sherif and associates) and organizational psychology during the 1950s (e.g. Sanford 1955; Kagan 1958; Kelman 1958).

Organizational Attachment is the psychological bond linking the individual and organization.

All these factors about the clients contribute to the Bank Managers Risk Perceptions towards MSME. In the cases where the Risk Perceptions are high, Bank Managers directly reject the applications. If the Risk Perceptions are medium or low the Bank Manager accepts the filled loan applications and actually assesses the applications on different parameters to identify the type of risk. Further Risk Handling Techniques are used accordingly.

#### **RISK ASSESSMENT**

Risk Assessment is recognized as a methodical process of quantitatively or qualitatively describing risk (Daneshkhah, 2004). The Risk pertaining to MSME proposals is perceived and then assessed by evaluating borrowers' credibility.

Following are the types of Risks in Lending to MSMEs identified from literature - Risk of Adverse Selection & Risk of Moral Hazard

Risk of Adverse Selection is a risk involved or errors occurred while evaluating the Loan proposals. According to Stiglitz and Weiss, 1981, the banks have incomplete information regarding the

underlying quality of projects and management of the small firm. This gives rise to the Risk of Adverse Selection. This risk arises before the Bank Manager takes the final decision regarding the loan proposals.

Risk of Moral Hazard is a risk that arises out of an inability of banks to monitor entrepreneurs once a loan has been made to ensure that they act in the best interests of the bank. (Edwards and Turnbull, 1994). This risk arises because it is too costly for the bank to monitor small firms' projects. (Binks and Ennew, 1996).

### RISK HANDLING STRATEGIES

As per Lane and Quack 1999, there are two distinctive Risk Handling Strategies in banking literature. They are – Externalisation form and Collectivist form.

*Externalisation:* In Externalisation form, the risk handling is transferring the risk to the customers. This is done by the use of interest rate to price for risk differentials. (Cosh and Hughes 1994). Another form of transferring risk to the customers is to ask for higher collateral for loans. And the last method is intensive monitoring.

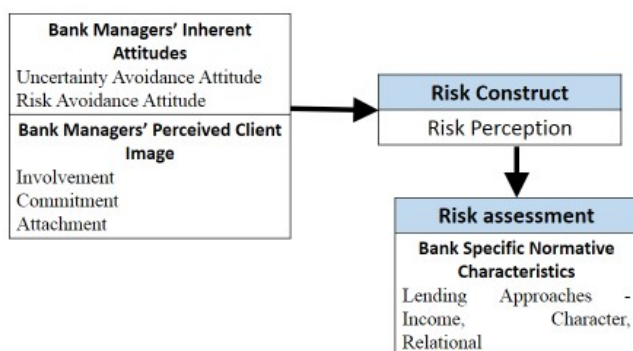
*Collectivist:* In Collectivist forms, the risk handling is done by sharing the risk with intermediary organizations which could be state governments such as Credit Guarantee Trust for Micro and Small Enterprises (CGTMSE) schemes offered by the Government of India.

### EXPLORATORY CASE STUDY AND LITRATURE REVIEW –LEADING TO MODEL DEVELOPMENT

The factors identified from exploratory interviews and literature review put together can be classified under the headings of Bank Managers' Inherent Attitude, Bank Managers' Perceived Image of clients and Bank Specific Normative Approaches. These factors will lead to two broad Risk Constructs - Risk Perception and Risk Assessment and further Outcomes which are Risk Handling Strategies represented in Table 2.

Table 2--Risk Constructs and their Antecedents

#### EXPLORATORY STUDY & LITERATURE REVIEW



#### CONCLUSIONS AND FUTURE RESEARCH ISSUES

It is thus posited that the antecedents of the risk constructs are based on two broad categories, namely, Bank Managers' Inherent Attitudes, Bank Managers' Perceived Image of the client. The Bank Managers' Inherent Attitudes could be tested based on two constructs from the literature, namely, *Uncertainty Avoidance* and *Risk Avoidance*. The current research makes a substantial addition to the research in the form of the second category that impacts the

*risk constructs, namely, Bank Managers' Perceived Image of the client. It was unearthed with detailed interviews with the Bank Managers that the Perception of Client Image, namely his project Involvement, Attachment and Commitment have a distinct bearing on Managers' Risk Perceptions.*

Hence, these were included in the model for testing. The relative importance to the factors could be discerned from a further quantitative testing on larger sample.

Particularly, the following hypotheses are posited for further testing:

*Hypothesis 1: Bank Managers' Risk Perceptions are dependent on Bank Managers' Inherent Attitudes.*

It is observed that Bank Managers' Inherent Attitudes are Risk Avoidance and Uncertainty Avoidance which have impact on their Risk Perceptions. Therefore it is posited that

*Hypothesis 1a: Bank Manager scoring high on Risk Avoidance Attitude (RA) will have high Risk Perception.*

*Hypothesis 1b: Bank Manager scoring high on Uncertainty Avoidance Attitude (UA) will undertake Risk Assessment first to Perceive Risk.*

*Hypothesis 2: Bank Managers' Risk Perceptions are dependent on Bank Managers' Perceived Image of the client.*

*Hypothesis 2a: Clients Higher Involvement as perceived by the Bank Manager leads to reduction in Bank Managers' Risk Perception.*

*Hypothesis 2b: Clients Higher Attachment to its project as perceived by the Bank Manager leads to reduction in Bank Managers' Risk Perception*

*Hypothesis 2c: Clients higher Commitment to its project as perceived by the Bank Manager leads to reduction in Bank Managers' Risk Perception*

### MANAGERIAL IMPLICATIONS

The model has implications for both the stakeholders, namely the banks who are the lenders and the MSMEs who are the seekers of finance. Both the stakeholders could suitably modify the factors based on the significance accorded to them.

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