

**Credit appraisal for working capital finance to
agricultural small and medium enterprises at Land
Bank**

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DECLARATION

I, Modisana Bogatsu, declare that this mini-dissertation entitled “Credit appraisal for working capital finance to agricultural small and medium enterprises at Land Bank” submitted for the degree of Master of Business Administration (MBA) at the North-West University, Mafikeng Campus, has not been previously submitted by me for a degree at this or any other university. I certify that this submission is my own work and all materials contained herein have been duly acknowledged by way of full references.

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ABSTRACT

The credit appraisal process plays a crucial role in a bank's lending function. It is part of the bank's risk management system that seeks to reduce exposure to credit risk. The main purpose of this study was to examine Land Bank's credit appraisal system with the aim of establishing the reasons for poor credit extension to agricultural SMEs, assess the relevance of Land Bank's credit appraisal process as well as to establish the strategies applied to improve this credit appraisal system and repayment of loans. This study was necessitated by the fact that SMEs in South Africa struggle to secure working capital needed to grow their businesses.

Data collection was done using structured questionnaires. The questionnaires were derived from the research questions and these comprised both close-ended and open-ended questions. The study focused on Land Bank employees who are in the credit department and SMEs in the agricultural sector, mainly farmers who applied for credit from the Land Bank, either approved or declined. The research findings reveal that Land Bank uses relationship lending, financial statements lending and Small business credit scoring lending techniques in extending credit to SMEs. However, the financial statement technique is more predominant than the other techniques despite failure by SMEs to provide proper financial statements. It was noted that most of the loan applications were rejected on the basis of lack of financial statements, inadequate collateral, and the risky nature of SMEs due to information asymmetry and project feasibility. High interest rate was identified as the main cause for non-performing loans. These findings corroborate the literature reviewed in this study.

The research recommends the establishment of a regulatory framework that seeks to eradicate constraints that hinder access to finance by SMEs. Good information dissemination systems that allow for effective credit checks on the credit history of borrowers should be in place and such systems should have sufficient flexibility mechanisms to allow for adjustments as market conditions change.

Keywords: Credit appraisal, Credit risk, Non-performing loans, SMEs

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LIST OF ACRONYMS

Abbreviation	Full description
DBSA	Development Bank of Southern Africa
DFI	Development Finance Institution
Land Bank	Land and Agricultural Development Bank of South Africa
NCA	National Credit Act
NCR	National Credit Regulator
NPLs	Non-performing loans
SARB	South African Reserve Bank
SMEs	Small to medium enterprises

1 CHAPTER ONE: OVERVIEW OF THE STUDY

1.1 INTRODUCTION

Banks play a pivotal role in the economic development of a country. Their intermediary function of mobilizing and channeling financial resources from savers to lenders is of critical importance (Akkizidiz, 2008). As noted by Odongo (2004) in return for lending banks earn interest, margins, commission and fees on loans as their revenue. However, in doing so they are exposed to three types of risks, i.e. operational, strategic and financial which incorporate credit risk. Credit risk is the most common and serious form of risk faced by banks in their endeavour to extend credit to borrowers. There is always a possibility that borrowers could default on the loan repayment. The magnitude and severity of loss resulting from credit risk has been a major cause of bank failures (Haron, 2004) as evidenced by what happened to African Bank in 2014. Therefore, there is a need for any bank to do a credit appraisal in order to determine whether to accept or reject a loan proposal. This involves an assessment of the borrower's financial position and ability to repay within the specified period. This takes into account the applicant's income, expenditure, dependents, employment history, repayment capacity and number of years of work. Precisely, the borrower's character, capability, collateral and capacity are all examined and evaluated.

The appraisal process also considers the borrower's expected future cash flows. However, it should be noted that the primary objective of a credit appraisal is to safeguard the financial resources of the bank and its customers. In addition, an appraisal includes gathering all the information relating to customers, business and projects pursued by the borrowers and assess the risks involved before granting credit (Berger & Fame, 2005). The economic, financial and technical feasibility of the project to be undertaken should also be assessed.

From the discussion above it can be concluded that SMEs face serious hardships in obtaining credit from banks and other financial institutions. On receipt of an application for credit, the credit provider subjects the borrower to a series of rigorous tests before approving the credit. The credit application is examined from many angles to safeguard the bank's money and to ensure that credit is granted to the right applicant. It should be

noted that lending activities in banks are guided by credit policies that are crafted in line with the National Credit Act of 2012. If the credit provider fails to do a proper appraisal there is a high probability that the borrower could default on repayments (Feder & Just, 1980).

A poor loan quality results from a weak information processing system (Ionnidou & Penas, 2010). This affects all the loan application stages right from the receipt of the application to its assessment, approval, monitoring and controlling. Therefore, banks should have an effective and proper credit appraisal system in place. It is in light of the above that the researcher examines Land Bank's credit appraisal system for financing working capital to small and medium enterprises.

1.2 BACKGROUND TO SME CREDIT PROVISION IN SOUTH AFRICA

There are quite a number of SMEs funding programmes in South Africa. It has been noted that Government effort alone would not adequately accelerate economic growth through SMEs financing. Therefore, banks play a paramount role in spearheading economic growth while the Government takes a facilitator's role.

The South African Reserve Bank (SARB) oversees and regulates the banking industry. As of November 2011, there were 18 registered banks in South Africa. The five major banks constitute 86 per cent of deposits in South Africa. These are Absa, FNB, Standard Bank, Nedbank and Capitec. This study, however, examines credit appraisal on financing SMEs at Land Bank.

It is important to note that since the dawn of democracy in 1994 the South African financial sector has gone through substantial transformation mainly in terms of regulatory arrangements, product development and leveling playing field (fair competition). There are three financial regulators in South Africa, namely, the National Credit Regulator (NCR), the Financial Services Board (FSB) and the SARB. This research concentrates on the National Credit Regulator as it relates more to the research questions under investigation. There is a big challenge in terms of how the three collaborate and agree on operational issues without overlapping in each other's roles. The SARB's role is to supervise all financial institutions in order to instill financial prudence.

1.3 OVERVIEW OF THE LAND AND AGRICULTURAL DEVELOPMENT BANK OF SOUTH AFRICA (LAND BANK)

In many developing countries, including South Africa, the government has intervened in addressing the challenge that is faced by farmers in obtaining agricultural financing. Land Bank offers tailor-made financial services to emerging and commercial farmers.

Land Bank is a government-owned development finance institution (DFI) with the sole mandate of financing agriculture and rural development to achieve food security and drive economic growth and development in South Africa (Land Bank Financial Report 2016/2017). Land Bank is a specialist agricultural bank guided by a government mandate to provide financial services to the commercial farming sector and to agri-business and to make available new, appropriately designed financial products that are intended to facilitate access to finance by new entrants into agriculture (SMEs) from historically disadvantaged backgrounds (Land Bank 2017).

Financial institutions, including Land Bank, have a mandate to provide agricultural credit to meet the financial needs of both emerging and commercial farmers. But, commercial banks have been reluctant to extend credit to SMEs in the agricultural sector due to the high risks associated with them (Lodha, 2011). However, finance remains an important pillar for the development of SMEs in the agricultural sector. The existence of Land Bank is critical, as their core mandate is to service areas where commercial banks cannot. Furthermore, the Land Bank's role is to ensure that SMEs in the agricultural sector can play a role in South African's economic growth. Land Bank provides funding to more than 700 emerging farmers who are supported via private sector intermediaries that provide technical support and access to markets (Land Bank Report 2016/2017).

1.4 PROBLEM STATEMENT AND CORE RESEARCH QUESTION

The problem statement guides the researcher on what has to be investigated and sets the research parameters as well as ensuring that the research remains on course. It is basically the core of the research.

1.4.1 MAIN PROBLEM

The primary purpose of the study is to explore the credit appraisal system applied by Land Bank in extending credit to small and medium enterprises in the agricultural sector in South Africa. SMEs face a perennial problem of access to finance (Financial Services Regulatory Task Group, 2007). This is compounded by the fact that SMEs are viewed as risky by banks and most of these banks are not keen to provide initial finance to SMEs. Start-up SMEs face a very daunting task of accessing finance from banks (Financial Services Regulatory Task Group, 2007). However, it should be noted that locational differences play a significant role in the financing of SMEs. SMEs in Gauteng and North West tend to have greater access to finance relative to those in the other provinces. Approximately 48% of formal SMEs are found in Gauteng (Finmark Trust, 2010; The DTI, 2008). In other provinces such as Mpumalanga and the Northern Cape, SMEs find it hard to access finance mainly due to their predominantly rural nature. Typical constraints facing SMEs are inadequate collateral, lack of financial statements, poor credit history (Financial Services Regulatory Task Group, 2007), the absence of viable business ideas, opacity and information asymmetry (GEM, 2014).

Land Bank currently fails to achieve its primary objective of adequately financing the agricultural sector, especially SMEs. As shown in the table below, for the year 2015/2016 the bank received credit applications totaling R2 billion but only R1billion was approved. That means 50% of applications were declined.

Retail credit statistics – YTD – March 2016

MONETARY VALUE AS AT MARCH 2016

MONTH	APPROVED	DECLINED	REFER BACK	REFER TO CRMC	TOTALS
30/04/2015	102,643,057	12,011,820	62,045,715	0	176,700,592
31/05/2015	107,961,414	52,900,000	20,701,053	7,804,675	189,367,142
30/06/2015	86,371,293	30,512,904	16,093,810	7,200,000	140,178,007
31/07/2015	102,004,066	8,575,581	37,484,916	10,245,100	158,309,663
31/08/2015	86,226,025	62,259,355	13,462,647	9,900,000	171,848,027
30/09/2015	89,378,383	30,495,518	40,204,637	0	160,078,538
31/10/2015	155,264,322	53,275,596	31,481,864	26,000,000	266,021,782
31/11/2015	140,783,044	10,009,501	20,107,344	0	170,899,889
31/12/2015	109,032,597	38,953,120	19,117,717	0	167,103,434
31/01/2016	61,201,756	28,517,100	33,002,065	10,000,000	132,720,921
29/02/2016	53,759,609	25,599,500		31,543,500	110,902,609
31/03/2016	44,644,078	67,469,692	22,829,176	13,500,000	148,442,946
Totals	1,139,269,644	420,579,687	316,530,944	116,193,275	1,992,573,550

Figure 1.1 Retail credit statistics – YTD – March 2016 (Source: Land Bank report, 2017)

The world over, SMEs financing continues to pose significant challenges. It is by providing credit and other financial services to enterprises that the agricultural financial sector could have its main impact in assisting the South African economy to grow and reduce stark poverty levels (SARB, 2015). Land Bank, as one of the dominant players in the domestic agricultural financial sector, faces a daunting task of supporting SMEs as they are now regarded as the engine for economic growth. As noted by Kamara, Murefu, Baresa, Anyanwu & Gil Seong (2011), the main challenge is that a large share of these enterprises is informal microenterprises whose establishment is often the result of lack of alternative economic opportunities. These enterprises are unable to produce formal financial accounts or formal guarantees and thus remain unbankable. However, it is not so much the overall level of credit, but rather the allocation of credit to the most credit-needy and more importantly credit-worthy that matters (African Development Bank, 2012). Hence, the need to examine Land Bank's credit appraisal system is undertaken in this study.

1.5 RESEARCH OBJECTIVES

The research objectives are set to:

- establish the criteria used to identify non-performing loans by the Land Bank
- establish the extent to which the credit profile of SMEs fit in with the credit appraisal system of the Land Bank
- determine the reasons for poor credit extension to agricultural SMEs.
- examine the relevance or appropriateness of Land Bank's credit appraisal process.
- identify the causes of non-performing loans.
- define the strategies that could be applied to improve the credit appraisal system and repayment of loans in Land Bank.

In line with the research problem (Leedy & Ormond, 2010), the following research questions can be stated:

- What criterion is used to identify non-performing loans by the Land Bank?
- To what extent does the credit profile of SMEs fit in with the credit appraisal system of the Land Bank?

- What are the reasons for poor credit extension to agricultural SMEs at Land Bank?
- What credit appraisal techniques are used to minimize credit risk exposure at Land Bank?
- What are the causes of non-performing loans at Land Bank?
- What strategies could help improve the credit appraisal system of Land Bank?

1.6 SIGNIFICANCE OF THE STUDY

The study provides a scaffold in policy formulation intended to tackle the challenges faced by credit providers in assessing the creditworthiness of borrowers. The study also contributes to the body of knowledge and literature on financing SMEs in developing economies, thereby adding to resources for other researchers. In terms of recommendations, the study provides valuable information on how banks should assess and recover loans granted to borrowers.

1.7 DELIMITATIONS AND ASSUMPTIONS

1.7.1 SCOPE

It is important for a research to be manageable and adhere to a specific research problem taking into consideration sample size and time constraints (Leedy & Ormrod, 2010). This research focuses on credit appraisal for working capital finance to small and medium enterprises at Land Bank.

The researcher anticipates numerous challenges in the research process. The following limitations were considered:

- Time and resources were a major constraint that hindered the researcher from thoroughly exploring all the aspects of the research.
- Obtaining accurate information from bank was difficult considering that they strove to maintain institutional confidentiality.
- Data collection process took more time than expected due to delayed responses.

1.7.2 ASSUMPTIONS

- i. It is believed that the research participants understand credit risk management.

- ii. Quick responses are expected from research participants.
- iii. Findings are representative of the financial sector.
- iv. Relevant, accurate and reliable data is obtainable.

1.8 DEFINITION OF TERMS

Credit risk is the likelihood of non-repayment of a debt by a borrower. The risk arises from the failure by the borrower to fulfill the terms agreed.

Credit policy refers to the terms and conditions that guide the overall lending business of a financial institution to ensure proper credit standards.

Commercial bank is a banking institution that takes depositors' funds and invests them and is also involved in the extension of loans to corporate and individual borrowers.

Non-Performing loan is a loan where full payment of interest or principal is no longer expected because the repayment period has elapsed. In other words, the loan is no longer earning interest in terms of repayment of the principal amount.

Credit appraisal techniques are procedures followed by credit providers when assessing the credit-worthiness of a prospective borrower. The procedures depend on the business' operating record, size and term of the loan, previous relationship with the borrower and collateral offered.

1.9 STRUCTURE OF THE STUDY

Chapter one contains the introduction of the study, background to SMEs credit provision, problem statement, the objectives, the research questions, importance of the study, delimitations and assumptions definition of terms and abbreviations. Chapter two provides an in-depth analysis of the literature available on credit appraisals. The study area, sampling techniques, target population, data collection procedure, research instruments used and data analysis constitute chapter three. Chapter four deals with analysis of data collected from the interviews and questionnaires and discusses the findings. Lastly, a summary of the research findings, recommendations and conclusion is given in chapter five.

2 LITERATURE REVIEW

2.1 INTRODUCTION

Literature review looks at the definition of credit followed by an explanation on credit appraisal systems and risk management by banks. The nature of SMEs in South Africa is also discussed as well as the nature of their credit profiles. The literature review section also discusses in detail the factors influencing credit extension, followed by a brief overview of major banks and their SMEs units. The chapter also highlights the need for credit appraisals, the credit appraisal process and discusses the determinants of credit accessibility by SMEs. Last, causes of non-performing loans, factors affecting loan repayments and models used in credit appraisals are discussed. The purpose of this segment connects to the impetus to examine Land Bank's credit appraisal system as this relates to SMEs.

2.2 DEFINITION OF CREDIT

Liu & Zhu (2006) define credit as “the ability of a business or individual to obtain economic value on faith, in return for an expected future payment.” Therefore, it means the fulfillment of financial obligations agreed upon depend on trust. This trust is often violated leading to loan repayment default or non-performing loans. According to research carried out by Mohammad (2008) on risk management in Bangladesh, the banking sector faces the main problem of non-performing loans. These non-performing loans lead to non-competitiveness of banking services in the face of globalization. In as much as banks desire to extend credit to borrowers and generate more income, they have to be prudent enough to recover the principal loan amount to safeguard depositors' funds. Due to this, banks have to adequately and correctly deal with the borrower's creditworthiness in order to minimize credit default risk. If a bank fails to recover loans granted to customers, the result is a decrease in capital that eventually leads to bank failure. Loan default is a very critical financial aspect of any bank (SARB Report, 2015). It is referred to as Credit risk. Therefore, there is a need for a proper assessment of the borrower's ability to repay the loan as already alluded to. Credit appraisal refers to all the steps taken by a bank in ascertaining the credit risk anticipated by checking the financial, economic and technical viability of a project.

The credit appraisal process starts with the receipt of an application from a prospective borrower, leading to credit extension and monitoring (Dhanuskodi, 2006). Credit appraisal determines the viability of the project and ultimately leads to determination of acceptance or rejection of the proposal. The bank receives two types of projects for the funding purpose. It could be a proposal for setting up a new company or working capital needs. A risk rating is assigned after the credit analysis. The risk rating is derived by estimating the amount of loss that the lender would suffer in the event of default and by estimating the probability of default by the borrower at a given confidence level over the life of the credit facility (Sharma & Kalra, 2012).

2.3 THE NATURE OF SMES IN SOUTH AFRICA

SMEs have common characteristics that differentiate them from large firms in terms of their accessibility to finance. The most frequently cited characteristic is firm size which is often determined by the number of employees and volume of sales. A major constraint experienced by SMEs is the control of the business by the owner (Berger & Frame, 2005). There is no separation of powers between the business and owner. It is difficult to separate business finances from personal finances. Such a conflict in the control eventually results in the owner misusing the finance thereby starving the business of essential financial resources (Hwarire, 2012).

The main criteria to ascertain viability commonly used by both developing and developed countries involve assets, annual turnover and the number of people employed. According to the World Bank (2012), small businesses are categorized into micro-scale (less than 50 employees), small-scale (50 employees) and medium scale (50-200 employees). But with the European Union, SMEs are firms with 10 to 250 employees and less than 50 million Euros in annual turnover.

In South Africa, the National Small Business Act as amended (Act 26 of 2003), defines a small business as a “separate and distinct business entity, including co-operative enterprises and non-governmental organizations, managed by one owner or more which, including its branches or subsidiaries, if any, is predominantly carried on in any sector or sub-sector of the economy mentioned in column I of the Schedule and which can be classified as a micro-, a very small, a small or a medium enterprise.

But this is not the case with South African banks that prefer to use annual turnover to define small businesses as shown in Table 2.1:

Table 2-1: Definition of SMEs by South African Banks

Bank	Turnover (SMME)
FNB	R10 million
Standard Bank	R10 million
ABSA	R10 million
Nedbank	R7.5 million

Source: Standard Bank, 2011; Absa, 2011; Nedbank, 2011; FNB, 2011

2.4 FACTORS INFLUENCING CREDIT EXTENSION TO SMES

Although SMEs make a substantial contribution to the South African economy, their development is often hampered by financing constraints (Tambunan, 2009). Yoshino (2006) noted that, although there are many potential SMEs in terms of numbers, there is a challenge stemming from excess demand of funding and limited proper schemes and volume of funding to SMES. Funding to SMEs cannot be channeled optimally because of strict selection processes that are a direct result of asymmetric information. Banks rely on non-verifiable soft information about borrowers. The possibility to off-load credit risk via securitization may undermine banks' incentives to screen borrowers at origination or to keep monitoring them once the loan is sold, giving rise to adverse selection and moral hazard. These asymmetric information frictions may further increase when the value of the collateral used to secure the underlying loan falls, as it is likely to do in crisis times (Chari et al., 2010).

Despite the South African government's National Development Plan (NDP) which prioritizes support for SMEs, banks are still hesitant to finance them as they are viewed as high risk clients. They encounter difficulties in obtaining accurate and reliable information regarding high potential and low risk SMEs. If they extend such credit to SMEs they charge them higher interest rates than large they do to big enterprises in order to offset the high risk associated with the SMEs. One of the high risks facing small and medium businesses is cash flow (Standard Bank, 2018). SMEs are unlikely to cope when the bank increases the interest rate on the loan.

A study by Udell (2004) revealed that nearly half of all small business (SMEs) in the United States comes from externally provided debt despite SMEs being considered unprofitable and unattractive.

Another related study was done by Rodriguez (2008) on bank financing to SMEs in Colombia with the objective of shedding light on trends and policy challenges by banks in Colombia. The research showed that bank financing to SMEs was becoming a strategic segment within Colombian credit institutions. It noted that the credit market for SMEs was still underdeveloped but displaying positive signs of great potential for sophistication as the market matures. However, it was sad to note that SMEs still face institutional and policy constraints in obtaining credit.

In Kenya, Kariuki (1995) researched on SMEs access to bank credit. A survey of 89 SMEs in service industries and manufacturing found that from 1985 to 1990 the average real volume of credit for the sample firms declined, except for 1986 which showed a slight increase of 1.5 per cent. It was noted that SMEs faced higher nominal interest rates and higher inflation rates in the 1980s. In addition to that, transaction costs of borrowing were found to be very high compared to interest costs.

In a related study carried out by Graham & Quattara (1996) on financial challenges facing SMEs in South Africa, the results indicated access to finance as a major constraint. This was a common reaction from SME owners interviewed on the question of what they perceived as constraints in establishing and expanding their businesses as well as performance of the ventures.

Extending credit to SMEs is perceived as more risky than doing the same for larger firms (Hall & Fang, 2004). Therefore, it should be noted that most of the financial institutions require collateral in the form of land or buildings. As noted by Bhattacharya (2000), the value of such collateral is usually very high, making it hard for SMEs to provide such collateral. Inadequate capital, poor asset base, and high failure rates render SMEs unattractive to good deals in terms of loans and interest rates (Sia, 2003).

In a study carried out in Malaysia, it was noted that in most countries SMEs have difficulty in accessing finance due to lack of the necessary systems that provide transparent information to investors or lenders (World Resources Institute, 2009). In addition, as

mentioned earlier, these SMEs cannot provide the high collateral required by banks. It was noted that SMEs in Malaysia operate in a much less supportive environment where opportunities to tap into formal credit providers are fewer than those available in developed economies. In most cases SMEs are considered too big for microfinance lenders and too small for the commercial lenders. Financing SMEs is therefore considered unattractive business as perceptions characterize SMEs as high risk enterprises that entail high transaction costs. This perception has resulted in mismatch between the bank's requirements and the accounting and management practices common among SMEs as well as the lack of suitable credit scoring mechanisms for the SMEs (Wendell & Harvey, 2006).

Rwigema & Venter (2004) noted that managerial competency plays a critical role in the success or failure of small businesses, especially in new SMEs (Kew & Kew, 2009). It is sad that most small businesses do not have appropriate management skills. As noted by Martin & Staines (2008), this problem is compounded by poor education and training of those running the SMEs. Managerial competencies are measured in terms of experience, training and knowledge of the industry.

However, Osborne (1993) thinks differently and asserts that managerial competence is of no consequence to the growth of SMEs. Having an appropriate business concept and the ability to stimulate capital growth are the critical factors in starting up a business. To guarantee success, there has to be an understanding of economics, unsaturated markets, hospitable environment and cash flow dynamics of the industry.

2.5 A BRIEF OVERVIEW OF SOUTH AFRICAN BANKING SECTOR

South Africa has a well-developed banking sector that has gone through the test of time. The sector is well-regulated and compares favourably with those of the developed world. That is the main reason why most foreign investors were attracted and continue to maintain their presence in South Africa with stakes in major banks. Out of 148 countries in the 2013/14 World Economic Forum Global Competitiveness Survey, the SA banking sector has been ranked 3rd (Lodha, 2011)

Since the advent of democracy, many changes have occurred in the South African banking sector. The regulatory environment has changed for the better. The sector was

liberalized, resulting in increased product offerings and competition from smaller banks which targeted the low-income and the previously unbanked market. Currently, the SA banking industry has 17 registered banks, 2 mutual banks, 14 local branches of foreign banks, 2 cooperative banks and 43 foreign banks with approved local representative offices. Standard bank, ABSA, FNB and Nedbank are the four major banks representing 83 per cent of total banking assets. Below is a brief overview of the SME units of South Africa's four major banks.

2.5.1 STANDARD BANK

Standard Bank is the largest in terms of assets with a market share of 25 per cent. The bank offers a variety of products and services, some specifically designed for SMEs, like the Khula-guaranteed loans, business term loans, debtor finance, bank overdrafts and business revolving credit loan plans (Standard Bank report, 2011). In addition, the Bank provides many training programmes and other support initiatives aimed at assisting SMMEs in the South African economy.

Standard Bank acknowledges the importance of delivery into the BEE market and has created a business unit (Enterprise Development) to provide financing solutions to the SMEs market (Standard Bank report, 2018). The focus of this division is to provide black SMEs with access to finance. Standard Bank won the 2014 South Africa Frost & Sullivan Award for Customer Value Leadership in this regard. The award was based on the global growth consulting firm's recent analysis of the market for SMEs support financial services. It acknowledged Standard Bank's recognition of SME clients' need for on-call services throughout the day by introducing a command centre for the processing and turnaround of SMEs loan applications within 48 hours.

2.5.2 FIRST NATIONAL BANK (FNB)

FNB constitutes 20% of total bank assets in South Africa. The bank has got a specialized business unit called FNB Solutions which provides tailor made for start-up businesses (FNB, 2006). The Bank works with several partners, one of which is Vumela, established in 2009 by FNB Business Banking and Edge Growth to work together in creating an innovative model that filled the gaps in the current SME funding and support landscape (FNB, 2018). While Vumela is an SME growth fund, it also functions as FirstRand's primary Enterprise Development and Supply Development vehicle, able to fulfil both SME

funding and growth needs, and corporate ESD requirements. Vumela was capitalised by FirstRand in 2010.

2.5.3 NEDBANK

The bank prides itself of having small business advisors at some of its branches offering expertise in franchise-related information. This helps a lot in safeguarding SMMEs from unscrupulous franchisors (Nedbank, 2011). In this area, Nedbank has assisted in job creation, training and mentorships of SMEs.

The bank formed collaborative partnerships with various municipalities to promote SMEs in terms of capacity-building and mentorship (Nedbank report, 2018). The training programmes are meant to infuse theory with practical aspects of business management. Nedbank contributed R2, 7 million in mentorship funding for the development of these SMMEs, with 2 977 job opportunities created, R41 million total lent thus far and zero rand being written off for the past five years (Nedbank report, 2018).

2.5.4 AMALGAMATED BANKS OF SOUTH AFRICA (ABSA)

Like FNB, ABSA also constitutes 20% of total bank assets. The bank has many small business support centres dotted all over the country and dedicated solely to SMMEs. Each centre has got dedicated and specialized advisors who provide support to start up or established SMMEs. The bank avails finance to both start-ups and existing businesses.

Through its various Enterprise Development (ED) initiatives, Absa is committed to assisting emerging black SMEs in South Africa grow and prosper (ABSA, 2018). ED is an integral part of the Barclays Africa Shared Growth Strategy and contributes to the wider National Agenda of promoting a thriving SME sector to enable economic and social development in the country.

2.6 THE NEED FOR CREDIT APPRAISAL

Credit appraisal plays a critical role in the lending process. It has been noted by Yoori Je Cho (1989) that without a proper credit analysis banks experience problems of non-performing loans (NPLs). This results in constraining credit supply as noted by Shijaku and Kalluci (2013), using Vector Error Correction Mechanism (VECM) in the Kenyan banking sector. The findings are in line with Suryanto (2015) who observes that NPLs

significantly affect the level of efficiency of banks, mortgage interest rates and bank liquidity. A good credit appraisal system assists the bank in making financially prudent decisions.

The ability and willingness of the borrower to repay a requested loan in accordance with the terms and conditions of the loan agreement is determined by a credit appraisal (Reed & Gill, 1989). It is important for the bank to exercise prudent lending because reckless lending will not only negatively affect the bank, but depositors and investors are affected as well. Therefore, there is need for the bank to maintain its integrity and market confidence through prudent lending.

Njanike (2009) noted that a number of financial institutions collapse due to inefficient credit risk management systems. The demise of Zimbabwe's banks in the 2003/2004 bank crisis points to poor risk management systems. The research also identified, among other things, poor corporate governance, chronic liquidity challenges and diversion from core business to speculative non-banking activities as factors that caused the crisis. There is also need for banks to develop and implement credit scoring and assessment methodologies, review and update the insider lending policies and adopt prudential corporate governance practices.

2.6.1 CREDIT APPRAISAL PROCESS

Basically, SMEs apply for loans for either working capital finance or for term loans. The credit appraisal process is explained below. As highlighted by Sharma & Kalra (2015) the credit appraisal process may take the following sequence:

Receipt of application from the applicant by the bank or financial institution

The first stage involves verifying the status of the applicant to determine the procedures to be followed. Dealing with an existing customer is easier, efficient and time saving, unlike a new customer that requires a lot of background checks.



The meeting with the firm's principals

Step two depends on the type of relationship with the customer. If there is a good relationship, the required information can be obtained by telephone. That means step two may not be necessary. However, in instances where there is no close relationship with the potential customer, step two is necessary for decision-making. The loan officer should be able to meet with the potential borrower and have an opportunity to acquire more information about the person behind the business.



Credit assessment and valuation of customer creditworthiness

At this stage all the information needed should be collected, both accounting and non-accounting (Anderson, 2001). This facilitates proper credit evaluation to make the right credit decision. As this is the most important stage, good and reliable information is of paramount importance. The necessary information for the process is estimated and evaluated during step three.



Interview and final decision

During the interviews, all banks should place importance on receiving good quality information in order to make the right decision. Complications usually occur at this stage because obtaining valid and reliable information from SMEs is difficult. The problem of information asymmetry and opacity is compounded by the failure in many SMEs to publish financial statements to the same extent as publicly held firms (Bruns, 2004).

2.7 DETERMINANTS OF CREDIT ACCESSIBILITY

This section focuses on the key factors that influence credit decisions. The bank's two main functions are to accept deposits and lend money. It is believed that commercial banks obtain the bulk of their income from extending credit to borrowers. Therefore, if this is done responsibly and prudentially, the bank experiences growth and prosperity. In a study carried out by MacDonald (2006), it was revealed that there are basically 7 factors that banks should consider in their credit appraisal systems. Therefore, before extending

credit, banks should fulfill the seven C's of Credit appraisal namely: character, capital, capacity, collateral, condition, control and common sense.

2.7.1 COLLATERAL

As noted by Kung'u (2011), secured loans are considered to have low risk of default hence attract low interest rates. Collateral provides security in the event of default by the borrower. It serves to reduce the problem of asymmetric information and moral hazard in asset-based lending (Bhaired & Lucey, 2010). Security cannot make a bad loan good but it definitely makes a good loan better. This lending method has been applied widely in bank financing. As noted by Bester (1987), collateral signals firm's level of risk because only low risk borrowers are willing to pledge high amount of collateral. For young and small firms, the level of collateral requirement is higher than in larger firms (Menkhoff, 2006). Studies have revealed the lack of collateral by SMEs as a major obstacle to accessing bank finance (Shinozaki, 2012).

However, it should be noted that security cannot substitute character or capacity of the borrower. In other words, security is valueless unless it is corroborated with character and capacity. All necessary legal formalities should be in place to ensure that the collateral can be realized easily when the need arises.

2.7.2 CONDITION

There is need for a proper investigation about the existing business (SWOT analysis) and the broader business environment. The bank should take into account the profitability of the business, the value of the account and the source of repayment. Indeed, Carey (1998) argues that the prevailing economic conditions are the single most important factor influencing credit extension to SMEs, but the bank should take into account all the factors at play. This also includes a look at government regulations.

In an expansionary phase of the economy there is relatively low NPLs, as both consumers and firms face a sufficient stream of income and revenues to service their debts. But, as the booming period continues, even low quality debtors receive loans and subsequently, when recession sets in, NPLs increase. Salas & Saurina (2002) infer the quick transmission of macroeconomic developments to the ability of economic agents to service their loans.

2.7.3 CHARACTER

Character plays a critical role in the lending process. Selection of the right borrower in terms of honesty and integrity is of primary importance. A proper investigation regarding previous dealings with the borrower, dealings with other players in the market and areas surrounding his place of business is also important. The history of the borrower provides an indication of what should be expected in future. Any suspicion or doubt regarding the prospective borrower's honesty and integrity renders the credit application unsuccessful. Unlike smaller banks, larger banks scrutinize the person behind the business. However, this depends on how the loan officer synthesizes information (Beaulieu, 1996).

2.7.4 CAPACITY

If the funds are not available, regardless of the character or reputation, it means you or your business has no capacity to pay back the loan. Proper analysis of financial statements and other factors (e.g., management's experience) help to determine the ability or capacity of the business to repay the loan. The bank considers the prospective borrower's qualification, experience and leadership qualities. The bank should have adequate information on how the borrower intends to repay the loan.

2.7.5 CAPITAL

This is the owner's equity, i.e. the amount of money invested to operate a business. The prospective borrower must have adequate stake in the business in order to earn or have the right to borrow. This ultimately determines the amount of credit that may be granted. The books of accounts are the main source of information about capital. The Bank does not want to head into slow payment or default situation, even if there is enough collateral. The bank needs to see what the financial resources that the borrower already has.

2.7.6 CONTROL

The internal control measures put in place by the business to safeguard its assets and financial resources are important measures that assure financial prudence (Thygerson, 1995). This involves having a proper audit trail that focuses on quality of management and the operational efficiency in terms of managing business by the borrower. Most banks prefer lending to certain industries where they have expertise in evaluating the quality of management in those industries. The bank must have a clear picture of how the business

is going to repay the loan. That means there must be evidence by way of a business plan that proposes how the borrower shall make use of the loan and possibly agree on repayment arrangements (Chowdhury, 2002).

2.7.7 COMMON SENSE

This can be referred to as a natural but practical and sensible way to make good judgment and exhibit appropriate behaviour. In terms of financing a project, the financial information provided should be reasonable enough to exhibit the ability of the project to generate sufficient cash flows to pay for itself (Mutwiri, 2003). Therefore, there is need for prudence and reasonableness in synthesizing the information to arrive at the right decision.

2.7.8 INTEREST RATE

Interest rate refers to the cost of borrowing, i.e. the amount charged on top of the original amount borrowed. As noted by Ogolla (2013), the higher the interest rate charged the lower the rate of borrowing by SMEs and vice versa. High interest rates, although advantageous to the lender, discourages borrowing by SMEs. Most SMEs fear that they will pay back huge amounts if they fail to honour the terms of the loan. Some banks, during the screening of potential borrowers willing to pay high interest rates are misconstrued as highly capable of repaying the loan. However, it should be noted that such high risk-takers are the worst in terms of repayment. According to Weinberg (2006), interest charged and the amount of debt affects repayment obligations.

2.8 CAUSES OF NON-PERFORMING LOANS

According to the Basel Committee 2006 (Saita, 2007:94), “a default is considered to have occurred with regard to a particular borrower when either or both of the following two events take place:

- The borrower is past due more than 90 days on any material obligation to the lender.
- The lender considers that the borrower is unlikely to pay its credit obligations in full, without recourse by the lender such as realising security (if held).

As noted by Islam (2005) the concept of non-performing loans is not a new phenomenon in any economy. Rather, it is now an established culture. Business and people alike are no

longer afraid of being declared bad debtors. Defaulting can be attributed to many aspects that can be classified as customer specific, bank specific and external. External factors refer to exogenous factors like the economic downturn. This is the situation currently obtaining in South Africa. The poor economic performance of the economy and the subsequent down grade in credit rating of the economy has resulted in a decline in buying power and this has witnessed a proliferation of bad loans. The increase in the level of poverty has affected the borrower's capacity to repay loans, the value of collateral and the condition of the economy (Mutwiri, 2003).

The other customer specific challenges could be when the borrower blatantly refuses to pay on time and in some instances skillfully avoids payment through taking advantage of the weak legal system (Hempel, *et al* ,1994). This becomes difficult for the bank to assess the character of the borrower. Bank specific factors are more problematic. They range from: moral hazard, reduced attention by borrowers and loans sanctioned by corruption (Waweru, *et al* 2009). This is whereby loans are sanctioned to satisfy self-interested behaviour. In other words, they engage with clients who corrupt the total system for self-gain. These result in an institutional system that is too politicized (Islam, *et al*, 2005) and this does not augur well for the economy. In the past, it was easier to get a loan from a financial institution as long as the borrower had security without considering the ability to pay (Mutwiri, 2003). It was not even necessary for the bank to assess the character of the customer. The bank could pay attention to the customer through regular inspections of their activities (Dhanuskodi, 2006). It should also be noted that the problem of non-performing loans is exacerbated by insider lending and lending at a high interest rate to borrowers in the most risky segment (SMEs) of the credit market (Waweru, *et al*, 2007). An increase in interest rates weakens borrowers' debt servicing capacity, more so if loan rates are variable. Therefore, NPL is expected to be positively related to interest rates.

2.9 MODELS USED TO APPRAISE SMES LOAN APPLICATIONS

Various models are used by South African banks to evaluate loan applications from SMEs. As noted earlier, SMEs have become the engines of economic growth and as such receive substantial amounts of credit from banks. This has increased the banks' exposure to credit risk thus calling for stringent measures in assessing and granting loans to SMEs. South African banks mainly use three models for credit appraisal (Madanda, 2010).

The accounting-based model makes use of accounting ratios in advancing loans to SMEs. The bank analyses the firm's books of accounts. The idea is to limit the problems of adverse selection and moral hazard. The accounting-based approach uses the Multiple Discriminant Analysis (MDA) and logistic models in classifying probable company default. Despite having many weaknesses, this approach is considered the most appropriate as it uses financial ratios derived from balance sheets and income statements of the SMEs (Khorasgani, 2009).

Secondly, banks also make use of the credit scoring model. This is the most widely used model in measuring future loan performance. According to Feldman (1997), "credit scoring is the process of assigning a single quantitative measure, or score, to a potential borrower representing an estimate of the borrower's future loan performance". The credit score model is used to classify loan applicants into two categories, i.e. those likely to default and those that will not. Such classification involves logistic regression which produces estimates of the likelihood or probability of default by using qualities of the borrower and historical data on loan performance.

In the small business setup, for any score above the cut-off score, the application is referred to further assessments by specialized small business units that will later take it up to the business credit department for approval or rejection. The credit scoring used for SMEs lending is considered more intricate than those used in consumer lending which makes their application difficult (Feldman, 1997).

Kou, Peng, Shi, Wise & Xu (2005) came up with a variation of the credit score model built from multiple criteria linear programming. Instead of just estimating the propensity of default vs. non-default, the model considers four facets, i.e. non-bankrupt charge-off, bankrupt charge-off, delinquent or standard account. The main limitation of the models is that they are static in nature. Predictions about the risk of defaulting are done in fixed subsequent time frames. In other words, the dynamics of a borrower's repayment behaviour should be modeled over a period of time.

The third model is called the survival-based credit model. It measures the link between illustrative variables and survival to estimate default and repayment (Narain, 1992). In this case the bank investigates the timing when customers are likely to experience problems in order to affect proper credit management policies (Luoma & Laitinen, 1991). In other

words, the bank will be able to manage and monitor its profitable clients over a long period of time. It is in light of this that the researcher examines the appropriateness of the model used by Land Bank.

2.10 FACTORS AFFECTING LOAN REPAYMENT

Loan repayment is a process that needs to be monitored and followed up to ensure compliance. Banks have got different repayment mechanisms. Loan repayment can be negatively or positively affected by the prevailing socio-economic and institutional factors. As noted by Pissarides, Singer & Svejnar (2003), the behaviour of SMMEs is not yet well understood. There are many factors impacting on the operations of small businesses and their management of credit. This has been the subject of a lot of interest by researchers with huge contributions to the body of knowledge. It is important to note that productive credit granting to SMEs is always hindered by adverse selection, opacity, information asymmetry and moral hazard.

2.11 THE CREDIT PROFILE OF SMES IN SOUTH AFRICA

Most of the SMEs are in the retail sector, followed by manufacturing (SEDA, 2016). The two sectors show marked increases from 2010 to 2015 in South Africa that could be attributed to inflation. The real estate and business, community and construction sectors also witnessed significant real increases (see Table 2.2 below).

Table 2-2: SMMEs turnover

R Million	Dec-10	Mar-15	% Change
Community	14004	27856	99%
Construction	29192	57254	96%
Electricity, gas & water	1516	1872	23%
Manufacturing	130293	164685	26%
Mining and quarrying	8242	8814	7%
Real estate & bus services	46925	142846	204%
Transport	22168	33538	51%
Trade	207877	290140	40%

Source, SEDA, 2016

Unlike the mining and quarrying sector, SMMEs in the real estate and business services reels under a very high interest burden. The sector paid less interest in 2015 Q1, compared to 2010 Q4 as noted by SEDA (2016). See Table2-3 below:

Table 2-3: SMMEs

R Million	Dec-10	Mar-15	% Change
Community	80	195	144%
Construction	149	522	250%
Electricity, gas & water	32	59	84%
Manufacturing	1197	1231	-3%
Mining and quarrying	329	128	-61%
Real estate & bus services	3143	6345	102%
Transport	364	352	-3%
Trade	755	787	4%

Source, SEDA, 2016

It is important to note that between 70-80% of SMEs fail within the first five years of initiation (Lulalend, 2016) and the entire industry is deemed as a risky market for credit (TransUnion, 2018). Furthermore, TransUnion (2018) revealed that 40% to 60% of SMEs in South Africa do not have access to credit due to data that is inconsistent across credit bureaus and thus make it difficult for Banks to assess the potential credit risk of SMEs. The report by South African SME (2016) indicate that SMEs in South Africa face a number of challenges including lack of funding, insufficient cash flow, poor sales as well as competition from large and established businesses. This implies that the SME sector is unable to access loans from the banks due to lack of financial knowledge, collateral and credit history (Fatoki, 2010). SMEs lack credit history or successful credit records that banks could rely on in making investment decisions. Potential costs and time involved in collecting information on credit worthiness on SMEs discourages banks from lending to them (Newman, 2010).

SME specific factors such as informality, low quality accounting information and lack of adequate guarantees, the firm's credit history with the bank, owner's characteristics and purpose of the loan cumulatively complicate the assessment of the creditworthiness of SMEs, resulting in increased transaction costs.

2.12 CONCLUSION

The literature review highlighted that there are many challenges which banks face in their bid to extend credit to SMEs. The involvement of banks in this sector is limited by the factors of credit risk, liquidity and information asymmetry. Such challenges hinder the growth of the sector which is ironically considered the engine of economic growth in South Africa. The literature review highlighted the concept of non-performing loans, reasons for poor credit extension to SMEs, the importance of credit appraisal and causes of non-performing loans.

The literature review also explored three models that are currently used to evaluate loan applications from borrowers. These include credit scoring model, accounting-based model and survival-based credit scoring model. As noted in the literature review borrowers also face the dilemma of failing to manage and service their debt effectively. Moreover, factors affecting loan repayments were highlighted in this chapter. The subsequent chapter focuses on the research methodology and design adopted in order to provide answers to the research questions set out in the initial chapter.

3 CHAPTER 3: RESEARCH DESIGN AND METHODS

3.1 INTRODUCTION

This chapter deals with the research design and methodology applied in order to achieve the objectives of the research. Research methodology is the way data is collected and analysed by making use of processes, procedures and techniques (Pérez, 2011).

3.2 RESEARCH DESIGN

A research design is a plan of action that anticipates providing adequate answers to the research questions (Saunders, Lewis & Thornhill, 2009). It contains all the strategies employed by the researcher. Therefore, it is referred to as the master plan giving direction on how specific research questions are addressed.

According to Research website (2014), the research design shows all the major aspects of the research such as programmes, samples and measurements used to address the central research questions. It clears any doubts or ambiguities on how the research question is addressed. Therefore, in this study, the research design applied complies with both qualitative and quantitative aspects of this study.

Mixed methods provide an understanding of the research problems than either approach alone as it involves philosophical assumptions that guide the direction of the collection and analysis of data. It should also be noted that the mixed method research provides more robust insights and minimizes bias.

Sequential explanatory design is applied in this study. The purpose of using sequential explanatory design is to use qualitative results to assist in explaining and interpreting the quantitative facets of this study.

The data collection involves both primary and secondary data through the use of questionnaires. Such data is collected from customers of the Land Bank and staff at the credit department.

3.3 POPULATION

According to Kamuzora & Adam (2008) a population is the totality of objects under investigation. The definition concurs with that of Krefting (1991) where the researcher

considers a set of all the objects, subjects or members that comply with a set of standardized specifications as a population. This also tallies with Leedy & Ormrod (2010), who contend that a population is an aggregate set of cases or group of members which forms the basis of the study. It is practically impossible to study the whole population in a research. Therefore, the researcher identified a sample that generated outcomes representative of the whole population. In this study, Land Bank employees and customers make up the target population. The study focuses on Land Bank employees who are in the credit department and the SMEs in the agricultural sector, mainly farmers who applied for credit in the Land Bank, either approved or declined.

The staff members selected worked in the Credit Department, Customer Advisors, Operations Department and the managers of these divisions. It should be noted that customers in this instance specifically refer to those have taken a loan facility from the Bank.

3.3.1 SAMPLING TECHNIQUE

As mentioned earlier, a sample is representative of the whole population assumed to have characteristics of the larger population. It is defined by its size, representativeness and parameters of the sample, access to the sample and the sampling technique used (Cohen, 2000). A sampling technique determines the profiles of individuals who participate in the study (Creswell, 2010). The researcher, as noted by Johnston & Vanderstoep (2009) should be able to make acceptable generalisations relating the research findings on the sample to the entire population.

This study adopted a non-probability sampling technique, which does not need randomization from the target population (Cohen et al, 2011). It rather makes use of subjective methods in selecting the elements included in the sample. In other words, the samples are drawn in such a way that all the participants or units in the population do not have equal probabilities of being chosen.

Non-probability sampling is cheaper than probability sampling and can be carried out more quickly (Battaglia, 2008). It is the researcher's responsibility to determine the non-probability sampling technique applicable to the research. The choice depends on the nature, type and main objective of the study. In this case, the researcher's main purpose is

to investigate credit appraisal for working capital for SMEs at Land Bank. The researcher chose purposive sampling based on the target population meeting practical criteria such as proximity, willingness to participate and time constraints (Dörnyei, 2007).

Purposive sampling is used in this study because the respondents do not have an equal chance of being selected. The participants in this study are selected on the researcher's discretion due to the sensitivity of the research topic.

Purposive sampling is cheap, easy and the respondents are readily available. It makes use of the assumption that the members of the target population are homogeneous. That means there would be no difference with research findings obtained from a random sample (Leiner, 2014). The disadvantage of this sampling method is that it is likely to be biased and there is a problem of outliers due to high self-selection possibility (Bernard, 2002). Outliers are elements considered to be outside the scope of the data required.

3.4 DATA COLLECTION

This study applied both qualitative and quantitative research procedures. The qualitative research focuses on understanding the behaviour and life style of participants. It is actually descriptive and contextual in nature (Struwig & Stead, 2001). This provides for an in-depth understanding of the activities of the Land Bank with regards to their credit appraisal system and to inform the quantitative analysis.

3.4.1 QUESTIONNAIRES

In order to establish the credit appraisal system used at Land Bank to finance working capital for SMEs, structured questionnaires will be used as an instrument for data collection. As noted by Leedy & Ormrod (2010), a large number of respondents are involved and research options are usually predetermined. For precision in reporting quantitative research results, numbers are used (Fox & Bagat 2007).

The data collection procedure involved visiting the sampled respondents at Land Bank branches. This gave the researcher the opportunity to explain questions where necessary and to get accurate information from the respondents. The questionnaires are derived from the research questions set out for the study. It comprised both close-ended and open-ended questions and formed the basis of the analysis in the study.

The questionnaires designed consisted of questions on the respondent's socio-economic characteristics, how loan officers evaluated the credit worthiness of new applicants at Land Bank, the Bank policies and the procedures in financing SMEs. In addition, the section examined the credit appraisal system applicable to SMEs and lastly looked at the strategies used to improve credit appraisal system at Land Bank.

3.4.2 DOCUMENT ANALYSIS

A number of documents were reviewed. The purpose of the document review was to supplement the primary data collected by the researcher with information from annual and quarterly reports, previous research reports and financial statements generated by Land Bank. This allowed for triangulation which is a process of comparing data collected through interviews and questionnaires with Land Bank documents. It enhanced confidence in the ensuing findings as it filled the gap of missing data where it was not possible to get such data through interviews and questionnaires.

3.5 DATA ANALYSIS

Before presentation and analysis all data collected were organized and checked to ensure accuracy, validity and completeness. This facilitated proper presentation in terms of tabulation, charts and graphs generation and computation of percentage and frequencies through SPSS.

It should be noted that the data analysis applied both quantitative and qualitative methods. The quantitative methodology made use of spread sheets to populate the quantitative data collected through questionnaires. Descriptive statistics were then used to analyze the data with the aid of a Statistical Package for the Social Sciences (SPSS version 20). The analyzed data was linked to the five research objective, examined and discussed using content analysis in order to appreciate the credit appraisal system at Land Bank (Gibbs, 2007).

With respect to qualitative data analysis, the research findings are interpreted in the light of the research questions to check alignment with the objectives. This is made possible by firstly reducing the gathered data to manageable size, developing summaries and looking

for patterns. It should be noted that the method of data analysis was descriptive in most cases.

3.6 VALIDITY AND RELIABILITY

3.6.1 VALIDITY

In this study, a valid and reliable methodology was used. The questionnaires were pretested and the data was collected from reliable sources. According to Enon (1998), if a procedure or instrument used in the research is true, accurate, meaningful and right then that procedure is valid. Validity can be ascertained by considering the truth or falsity of the research data obtained (Krioting (1991). As noted by Leedy & Ormrod, (2010) a measurement is valid when it meets its purpose of measuring what it is intended to measure.

3.6.2 RELIABILITY

A measuring instrument is reliable if it provides consistent results when the characteristics being measured have not changed (Kothari, 1990; De Vos, 1998). This is supported by Polit & Hungler (1999) who define reliability as the degree of consistency with which an instrument measures an attribute. In other words, the instrument should have the ability to measure what it is intended to measure. It is difficult to assure reliability and validity separately, i.e. an instrument cannot be valid unless it is reliable (Tavakol & Dennick, 2011). Therefore, reliability and validity analysis were assessed first to test questionnaires to establish relationships and develop generalizations that contribute to existing theories.

3.7 ETHICAL CONSIDERATIONS

There researcher observed ethical considerations in carrying out the research (Kobus Mare, 2010) by adhering to what is acceptable (O'Leary, 2010). According to O'Leary (2010), the highest levels of ethics are anonymity and confidentiality of the respondent's identity. In this research participants were approached and made aware of the purpose of the research and those who felt otherwise did not participate. In other words, the researcher explained fully the nature of the research and respondent's rights to participate. Courteous treatment was observed and the participants' culture, beliefs, lifestyles, habits and emotions were considered at all times.

3.8 CONCLUSION

This chapter outlined the research methodology followed in the study. The logic was to come up with the correct methodology that would achieve the desired outcomes. The data collection instruments used involved interviewing, questionnaires and reviewing of Land Bank documents. It was noted in the chapter that ethical considerations were observed at all times. The next chapter deals with the research findings.

4 CHAPTER 4: DATA PRESENTATION AND ANALYSIS

4.1 INTRODUCTION

This chapter focuses on the presentation, interpretation and analysis of collected data. The Land Bank provided the researcher with Microsoft SharePoint platform to collect data from Land Bank employees in the credit division. Land Bank Participants were sent the Microsoft SharePoint link through their email to complete an online survey. One hundred online questionnaire links were sent to Land Bank participants and eighty questionnaires were completed and returned on Microsoft SharePoint tool. This was a statistically credible response rate considering that such research topics are sensitive to the Land Bank.

Another fifty set of questionnaires were printed and hand delivered to the Land Bank customers who operate SMEs who are referred to as emerging farmers. Twenty of these questionnaires were completed and returned. This was an acceptable response considering that farmers in most cases are busy and do not have time for surveys.

A total of one hundred questionnaires were completed and returned from Land Bank employees and Land Bank customers or emerging farmers. Responses were considered to be true and representative of the entire population. A statistical analysis of data was done using SPSS version 22 tool followed by interpretations and inferences.

4.2 SECTION A: DEMOGRAPHICS

A greater proportion of respondents were male as opposed to female respondents. Out of the hundred questionnaires that were completed and stored in a Microsoft SharePoint, 30% were female respondents and 70% male as shown in Table 4.1 This indicates that there are more males dominant in the agricultural sector and this could be ascribed to the heavy labour demands that possibly kept women out the sector.

Table 4-1 Gender * Level of education cross tabulation

		Level of Education					Total
		Grade 12	Diploma	Degree	Master's Degree	Doctorate /PHD	
Gender	Male	5	10	40	10	5	70
	Female	0	0	30	0	0	30
Total		5	10	70	10	5	100

Gender * Level of Education Cross tabulation

Table 4.1 shows that 70% of respondents have a university degree followed by 10% holding a Master's degree and 10% with a Diploma qualification. Only 5% of the respondents has Doctorate/PhD qualification. In general, the respondents all had some educational background though there is no clear specification whether this educational qualification focused on agricultural expertise.

Age Group

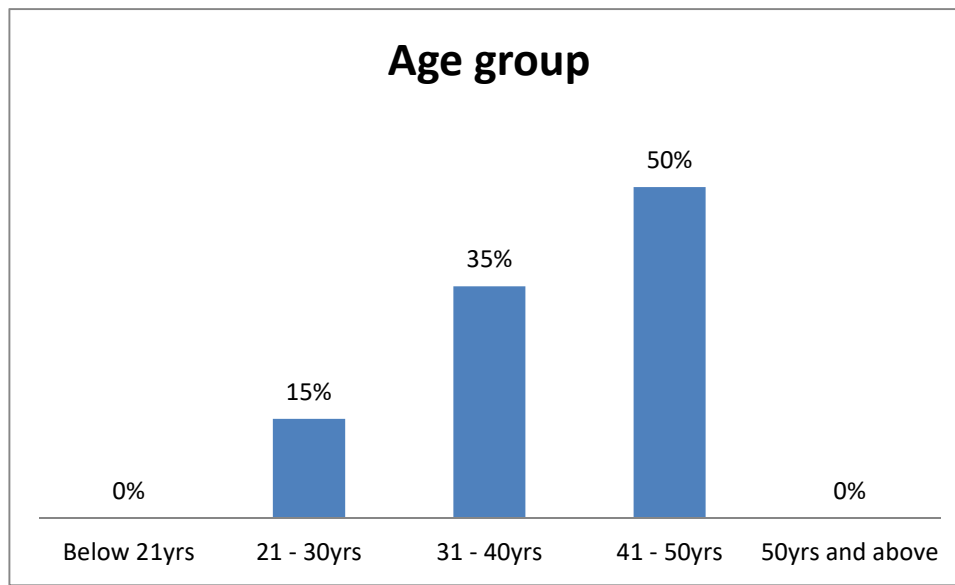


Figure 4.2 Age Group

The respondents were classified according to age groups. Figure 4.2 shows that fifteen (15%) of the respondents were aged between twenty-one and thirty years, thirty-five (35%) were aged between thirty-one and forty years, fifty (50%) were aged between forty-one and fifty. Hence, the majority of respondents were aged above between forty-one and fifty years. This suggests that young people are not interested in the agricultural sector or farming.

4.3 SECTION B: DECISION-MAKING TO LEND AND SET TERMS OF THE LOAN CONTRACT

According to MacDonald (2006), there are seven factors that banks consider in their credit appraisal systems and these are character, capital, capacity, collateral, condition, control and common sense (the seven Cs). The responses reveal that 50% of the respondents strongly agree that the background of the owner is important in the lending process (see figure 4.2). A moderate 30% agreed in this regard while 10% of the respondents were

unsure. The selection of the right borrower in terms of honesty and integrity is of primary importance. A proper investigation regarding previous dealings with the borrower, dealings with other players in the market and surrounding areas of the place of business is also very important in determining whether or not to extend credit facilities to the applicant.

A significant 45% of the respondents agree that the information from suppliers is crucial in the decision-making process whereas 15% of the respondents feel that it is not important. Only 10% of the respondents seemed unsure in this regard. Banks use information from suppliers in order to determine the business' repayment of credit patterns. Banks also use that information to establish the relationship that the owner has with the supplier as well as how the credit facility is serviced. In terms of the credit score, 50% of the respondents strongly agreed that the credit scores are factors that play a crucial role in the decision-making to lend and set terms of the loan contract and 30% of the respondents agree in this regard. While 15% of the respondents were unsure, only 5% of the respondents disagreed.

Decision-making to lend and set the terms of the loan

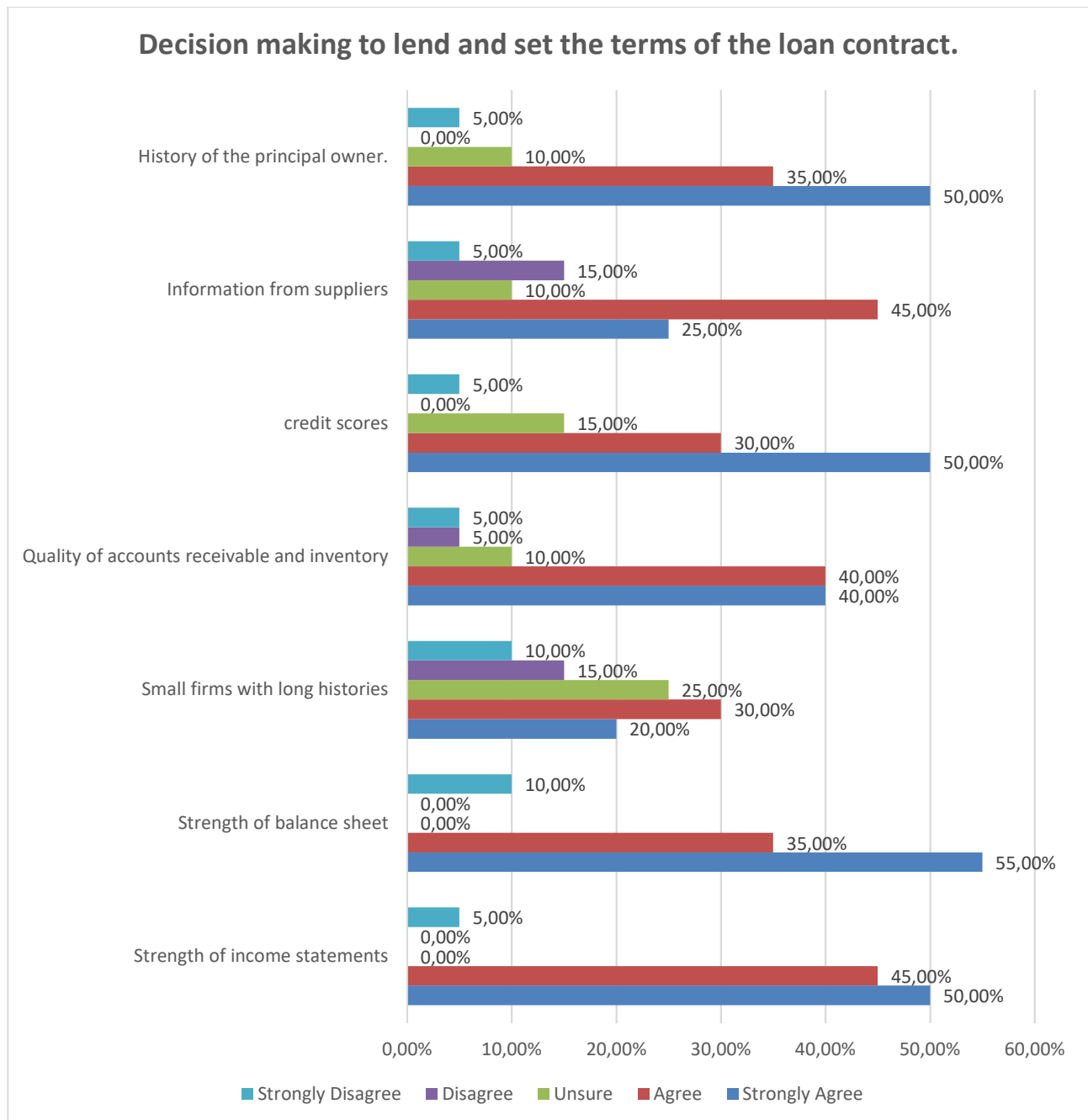


Figure 4.3. Decision making to lend and set terms of the loan

The quality of the accounts receivables and inventory is a very important aspect in the decision-making process because the accounts receivables are the amount of debtors that the business has, which is the cash that they are expecting in the near future. This enables the bank to determine whether the business would adhere to the terms of the loan contract or not. Inventory is also very important as it is the amount of goods which could be sold for cash. From the data, 40% of the respondents strongly agree that accounts receivables and inventory are important facets in the decision-making process, while another 40% of the

respondents agree in this regard. Only 5% of the respondents disagreed. 20% of the respondents strongly agreed that small firms with long histories were important in the decision-making process while 25% of the respondents were unsure. 30% of the respondents supported this statement. A small firm with long a long credit history is a very critical aspect as it is an indication that the firm has systems in place which ensure sustainability in this regard.

In terms of the strength of the balance sheet, 55% of the respondents strongly agree while 35% of the respondents agree with this statement. Only 10% of the respondents strongly disagree. The strength of the balance sheet is very important as it determines the amount of assets that the business has as opposed to the liabilities that it has, therefore determining the business' net worth.

4.4 SECTION C: CREDIT APPRAISAL TECHNIQUES

Credit appraisal plays an important role in the lending process (Yoori Je Cho, 1989). According to Je Cho (1989), without proper credit analysis, banks experience problems of non-performing loans. Figure 4.3 below indicates that 40% of the respondents strongly agree that they make use of asset-based lending techniques while another 40% supports this by agreeing in this regard. 10% of the respondents were unsure about this technique while the other 10% disagreed. In terms of the small business credit scoring lending, 45% of the respondents confirmed utilizing this technique while 35% of the respondents strongly confirmed utilizing this. 10% of the respondents were unsure of this technique.

Credit Appraisal Techniques

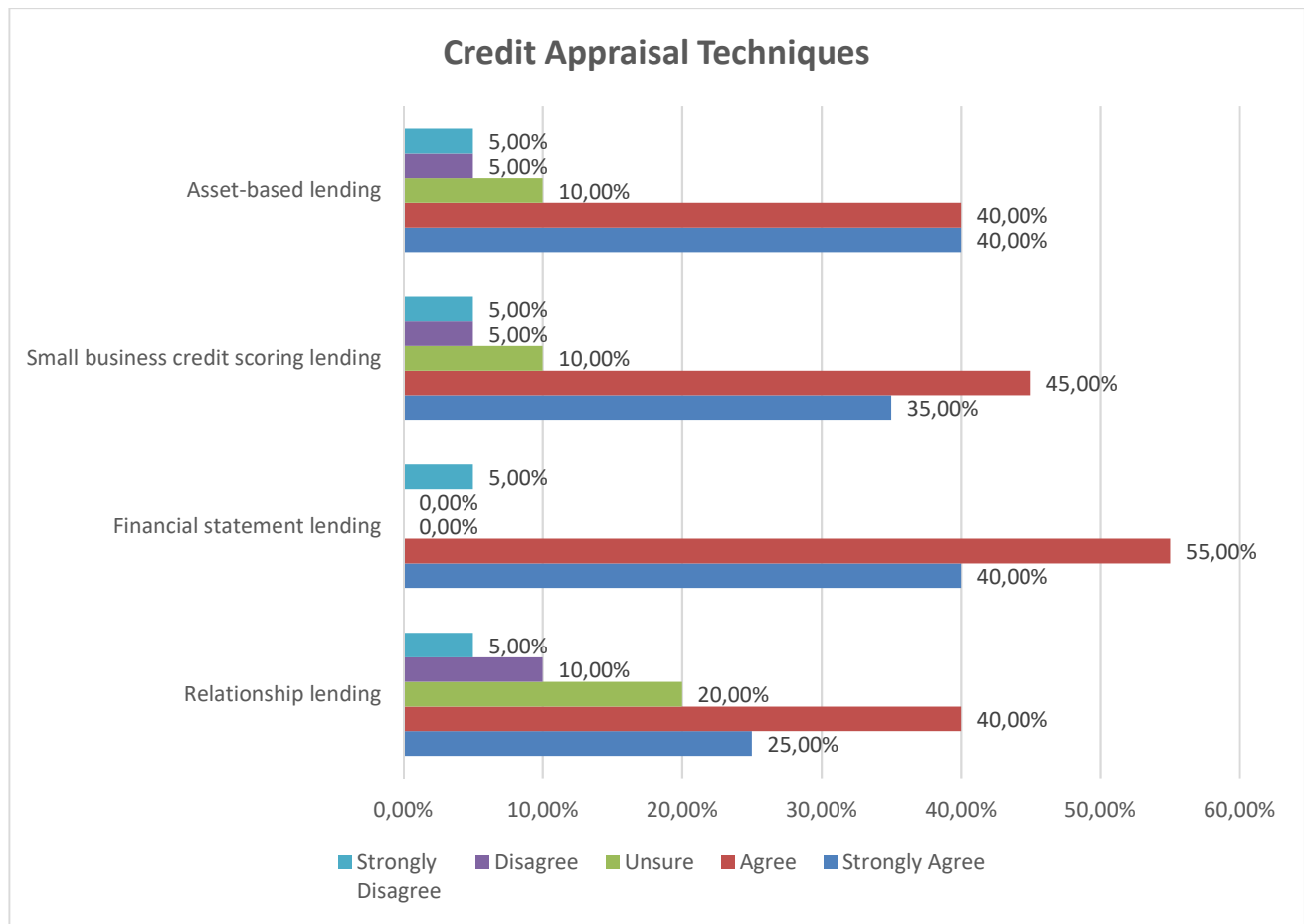


Figure 4.4. Credit appraisal techniques

The ability and willingness of the borrower to repay a requested loan in accordance with the terms and conditions of the loan agreement can be determined by a credit appraisal (Reed & Gill, 1989). The data shows that 55% of the respondents agreed that they used the financial statement lending technique while 40% of the respondents supported this by strongly agreeing. When using financial statements, one can determine if the business is profitable or not, establish their cash flow as well as net worth. These are important aspects in the credit appraisal process. In terms of the relationship lending technique, 40% of the respondents agreed to using this technique while 25% strongly agreed that they used the technique and it has proven to be beneficial in terms of credit appraisals. Data also shows that 20% of the respondents seemed unsure as to what this technique entails. Based on the responses received, the financial statement technique was the most preferred t as it seemed the respondents were more familiar with it as compared to the other techniques.

4.5 SECTION D: CHALLENGES FACED BY BANKS WHEN USING THE CREDIT APPRAISAL TECHNIQUES

Banks experience significant challenges when using the credit appraisal techniques. This is evident in the 35% of the respondents who agreed that the lack of accurate credit scores is one of the challenges faced by Land Bank, while 25% strongly agreed. 25% of the respondents disagreed in this regard. According to Wendel & Harvey (2006), the wide disparity between the bank's requirements and SMEs accounting and management practices resulted in the bank not having a suitable credit scoring mechanism. In terms of the presentation of fake real estate documents by clients, 35% of the respondents disagreed that it was one of the challenges, while 5% strongly disagreed. 30% of the respondents seemed unsure. Non-disclosure of financial interest in the firm was stated as one of the challenges faced by banks when using the credit appraisal technique. 35% of the respondents agreed to it while 20% strongly agreed. 30% of the respondents disagreed with this statement. The tendency of firms hiding their financial interests has a direct impact on the credit appraisal process as well as the decision-making thereof.

Challenges faced by the Land Banks when using the appraisal technique

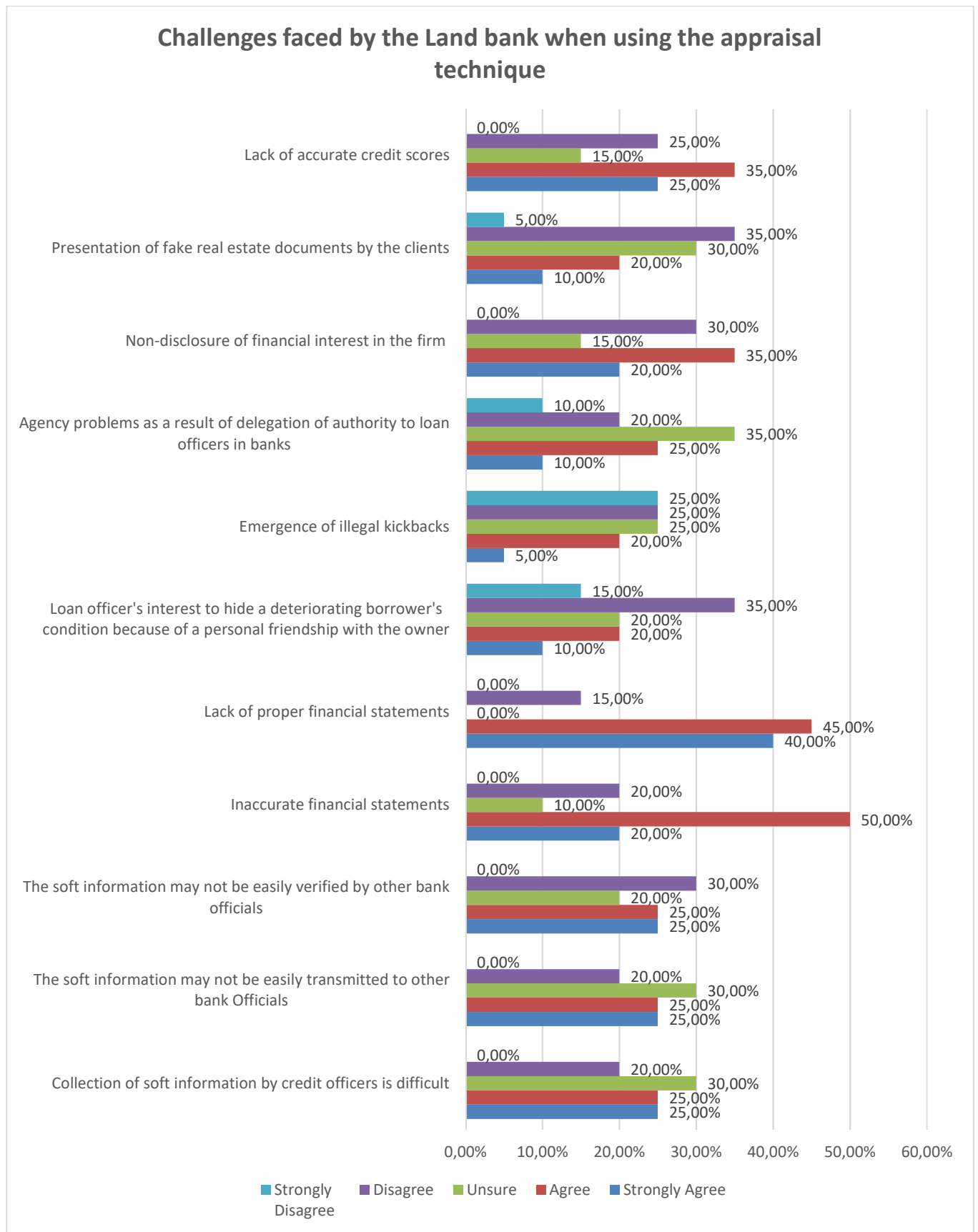


Figure 4.5. Challenges faced by the Land Bank when using the appraisal technique

Data gathered shows that 35% of the respondents were unsure if agency problems were one of the challenges faced by the Land Bank while 20% of the respondents disagreed. 10% of the respondents strongly disagreed in this regard which means that agency problems were not perceived as a concern when it came to banks using credit appraisal techniques. 25% of the respondents disagreed that the emergence of illegal kickbacks was one of the challenges faced by the Land Bank while 25% strongly disagreed in this regard. On the other hand, 20% of the respondents agreed that this was one of the challenges faced by the Land Bank and 5% strongly agreed. This shows that Land Bank have secure systems in place which limit such activities from taking place. 35% of the respondents disagree that one of the challenges that Land Bank faces was the fact that loan officers hid the deteriorating borrowers' condition due to personal friendships with the owner. 15% of the respondents support this by strongly agreeing while 20% of the respondents are unsure. Only 20% of the respondents agreed that this was one of the challenges that Land Bank faced while 10% of the respondents strongly agreed.

One of the challenges faced by Land Banks is a lack of proper financial statements provided by SMEs. From this study, it emerged that 40% of the respondents strongly agreed while 45% of the respondents agreed to this statement. Only 15% of the respondents disagreed. 25% of the respondents strongly agreed that soft information may not be easily verified by the bank officials while 25% supported this statement. While 30% of the respondents disagreed that this might be a challenge, only 20% of the respondents were unsure. 50% of the respondents were unsure if soft information was not easily conveyed to bank officials while 25% of the respondents agreed that this was one of the challenges that banks faced. 25% of the respondents strongly supported this statement. In terms of the collection of soft information by credit officers, 25% of the respondents strongly agreed and another 25% agreed that this was a challenge while 30% of the respondents were unsure. 20% of the respondents disagreed in this regard.

4.6 SECTION E: FACTORS THAT HINDER ACCESS TO SMES

4.6.1 MACROECONOMIC FACTORS

The macroeconomic factors identified were macroeconomic instability, exchange rate risk, high interest rates as well as the small size of the SME sector. According to the responses received, indications are that the respondents thought that all the factors mentioned above

were very significant obstacles in the exposure of SMEs. A significant 40% of the respondents identified high interest rates as a very crucial obstacle while 45% of the respondents believed that macroeconomic instability, exchange rate risk and small size of the SME sector were significant obstacles in this regard.

Macroeconomic factors

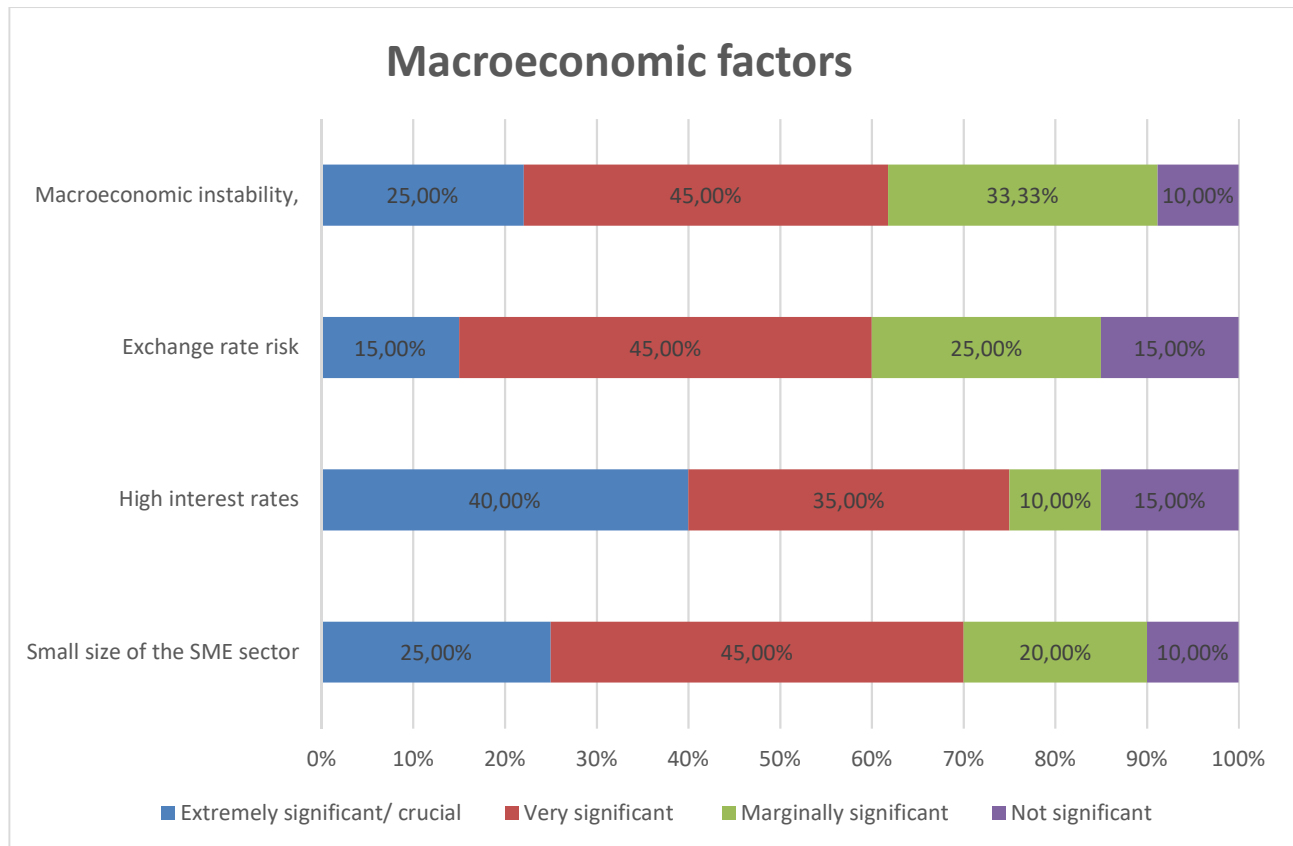


Figure 4.6. Macroeconomic factors

4.6.2 LEGAL AND CONTRACTUAL ENVIRONMENT FACTORS

Data shows that 40% of the respondents perceived collateral law to be an extremely significant factor, while 30% of the respondents found it very significant. In terms of judicial efficiency, 35% of the respondents found this factor very significant while 30% of the respondents found it marginally significant. 35% of the respondents were convinced that the bankruptcy regime played an extremely significant role in the legal and contractual environment factors while 30% of the respondents thought that it was very significant.

In terms of contract enforcement, 45% of the respondents said that contract enforcement played a very significant role while 20% found it very crucial. Only 5% of the respondents did not find it significant with respect to loans extended to SMEs.

Legal and contractual environment factors

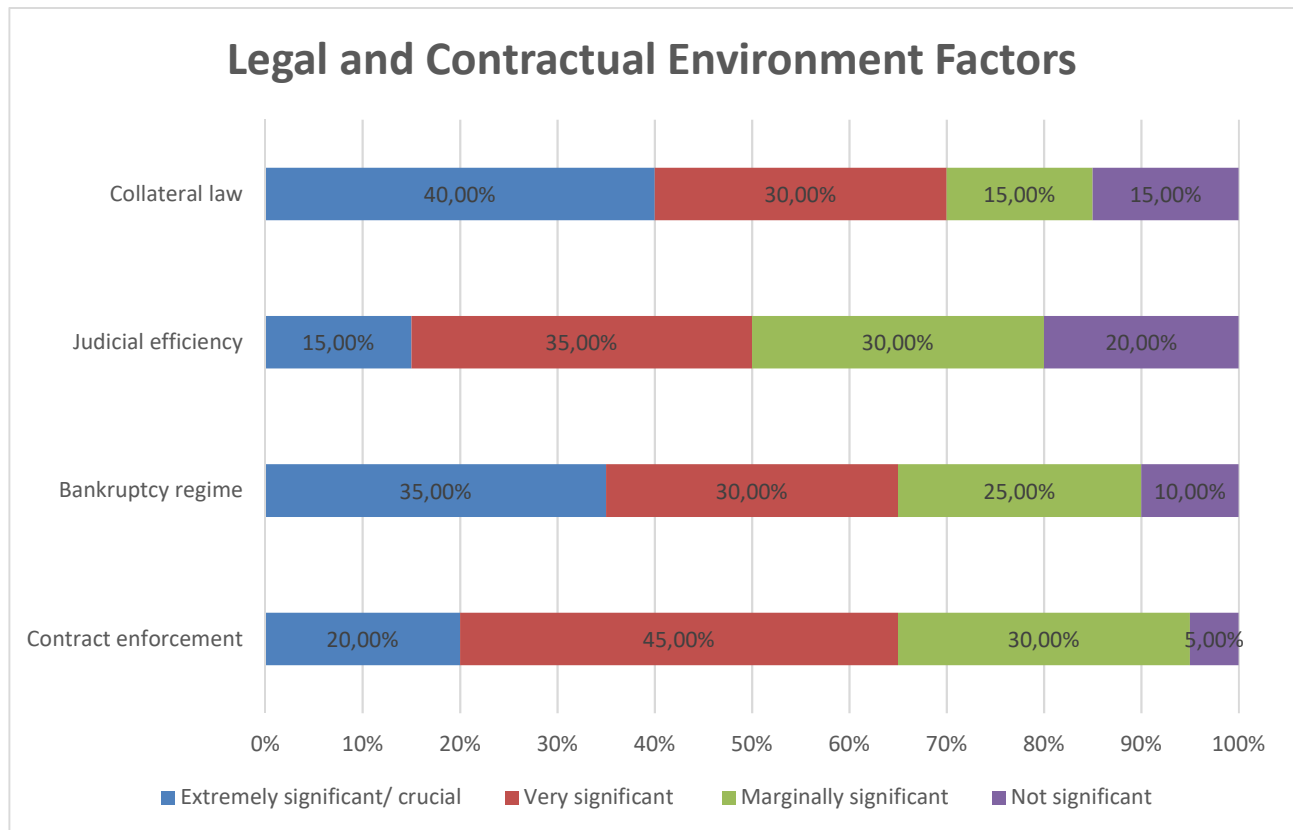


Figure 4.7. Legal and contractual environment factors

4.6.3 BANK SPECIFIC FACTORS

In respect of bank-specific factors, 30% of the respondents found this aspect crucial, while 20% believed that it was a very significant aspect. 15% of the respondents were persuaded that the difficulty in designing a product matching the SME segment needs was not significant. According to the respondents, 45% of them believed that the problem of lack of appropriate information technology tools was marginally significant while 15% of the respondents believed that it was very significant. 35% of the respondents believed that it was a crucial aspect. 30% of the respondents found the inability to diversify risk across borrowers as an extremely significant aspect while 25% of the respondents found it very significant. 40% of the respondents found it marginally significant.

Bank Specific Factors

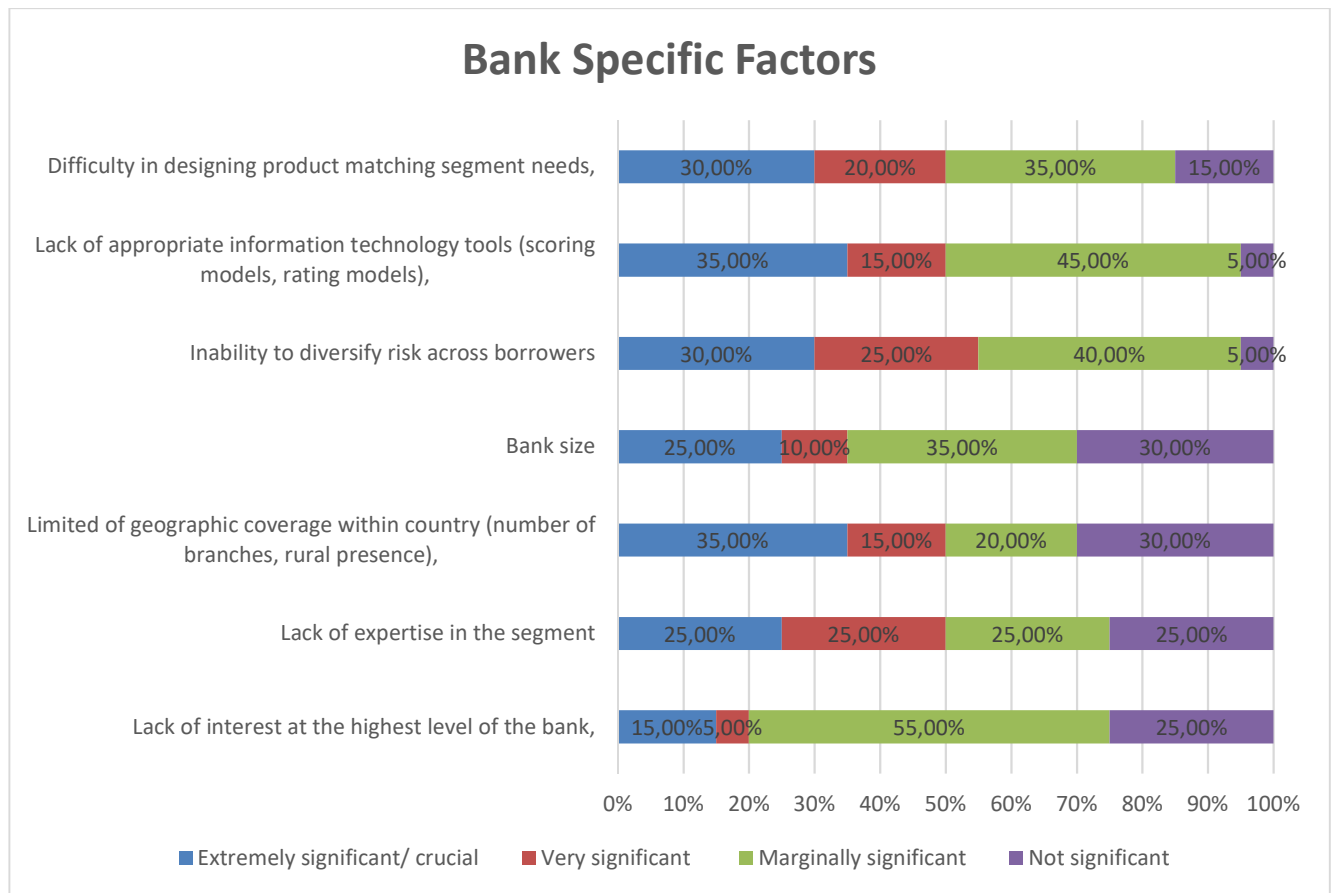


Figure 4.8. Bank specific factors

In examining bank-specific features, 35% of the respondents perceived bank size an aspect that was marginally significant while 10% of the respondents found it very significant. 25% of the respondents found it extremely significant. In terms of the limitation of geographic coverage within the country, 35% of the respondents found this aspect as crucial within the bank specific factors while 15% of the respondents found it very significant. 30% of the respondents found it not to be significant. 25% of the respondents found the lack of expertise in the segment as extremely significant while 25% of the respondents found it very significant. 25% of the respondents found it marginally significant while the other 25% found it not to be significant. In terms of lack of interest at the highest level of the bank, 55% of the respondents found this aspect as marginally significant while 5% of the respondents found it very significant. 25% of the respondents found it not to be significant.

4.6.4 SME SPECIFIC FACTORS

According to Standard Bank (2018), cash flow is one of the high risks facing SMEs and these entities are unlikely to cope when the bank increases the interest rate on loans. 60% of the respondents found the lack of adequate collateral as a crucial aspect in the SME specific factors while 25% of the respondents found it to be very significant. 35% of the respondents found the inability to prosecute the owner in case of default as a very significant aspect that hindered recourse to legal channels. 30% of the respondents found it marginally significant while 10% of the respondents found it not to be significant. In terms of the inability of SMEs to manage risk, 55% of the respondents found it to be very significant while 20% of the respondents found it to be marginally significant. 55% of the respondents found that the poor quality of financial statements was a very crucial aspect in the SME specific factors while 35% of the respondents found it very significant. 5% of the respondents found it marginally significant while 5% of the respondents found it not to be significant.

SMEs specific factors

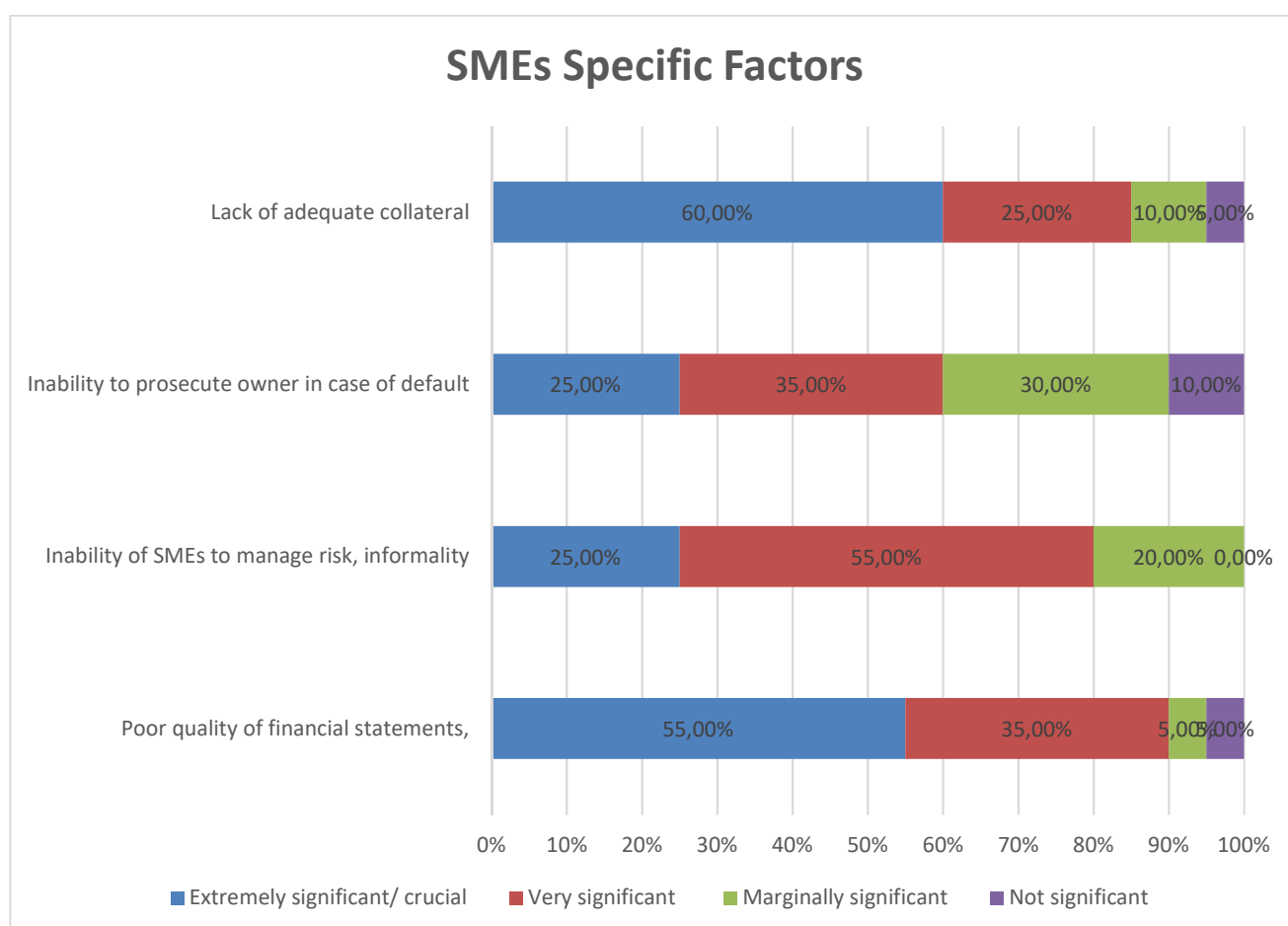


Figure 4.9. SMEs specific factors

4.6.5 NATURE OF THE LENDING TECHNOLOGY TO SMES

In terms of difficulty in attaining scale economies, 50% of the respondents found this very significant while 15% of the respondents found it extremely significant. 40% of the respondents found the difficulty in standardizing products as very significant while 25% of the respondents found it extremely significant. The other 25% of the respondents found it marginally significant. The other 25% of the respondents found it marginally significant.

Nature of the lending technology to SMEs

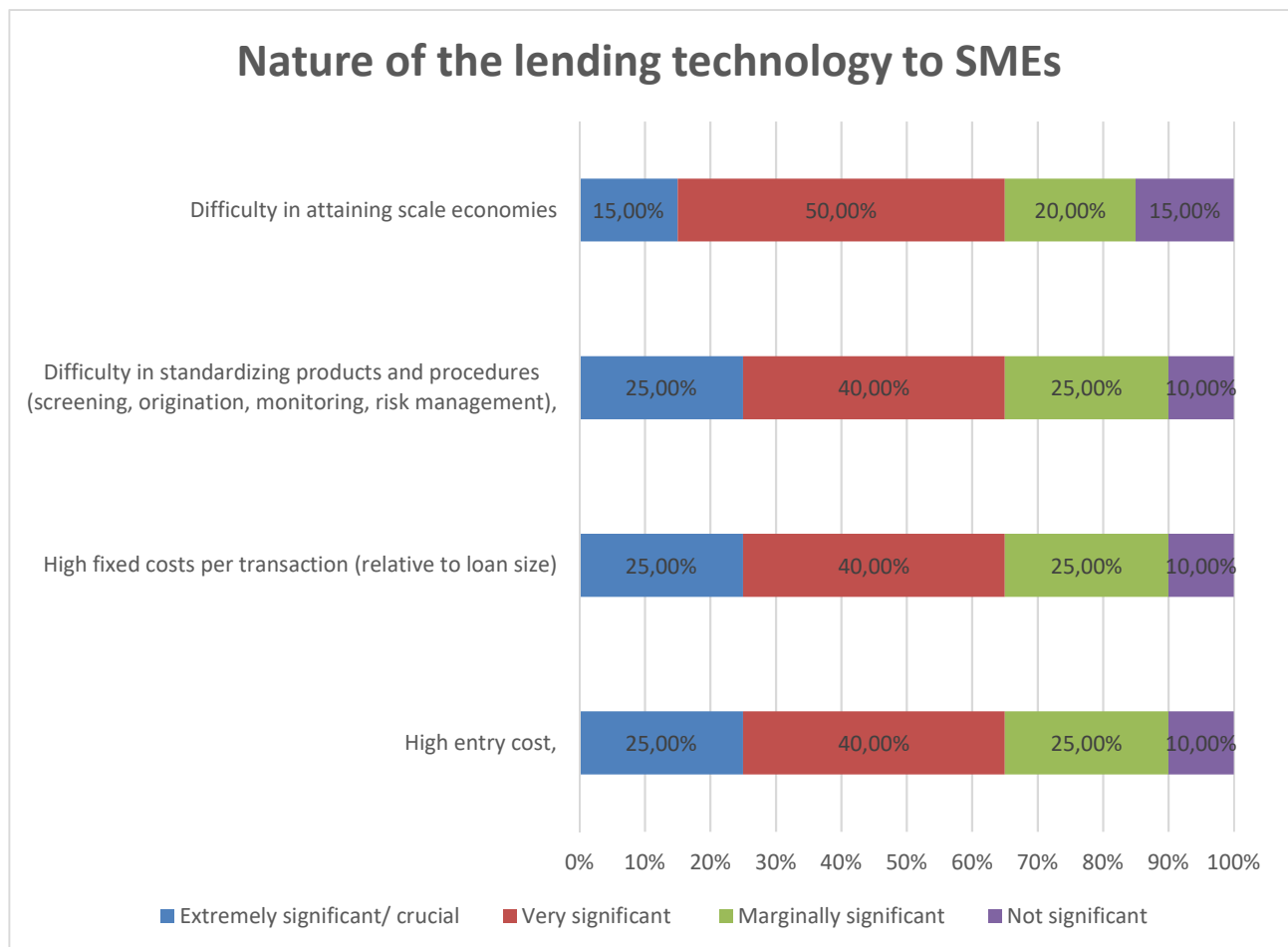


Figure 4.10. Nature of the lending technology to SMEs

According to the respondents, 40% of them found high fixed costs per transaction as a very significant aspect while 25% of the respondents found it extremely significant. 10% of the respondents found this aspect as not being significant. 40% of the respondents found the high entry cost as a very significant aspect while 10% of the respondents found this as not being significant.

4.6.6 LACK OF ADEQUATE DEMAND

Data obtained shows that 35% of the respondents agreed that there is a demand for loans and credit lines, but it was from customers that were not credit worthy and found this aspect as being crucial while another 35% of the respondents found it very significant. In terms of lack of sufficient demand, 30% of the respondents found this as not significant while another 30% found it to be marginally significant.

Lack of adequate demand

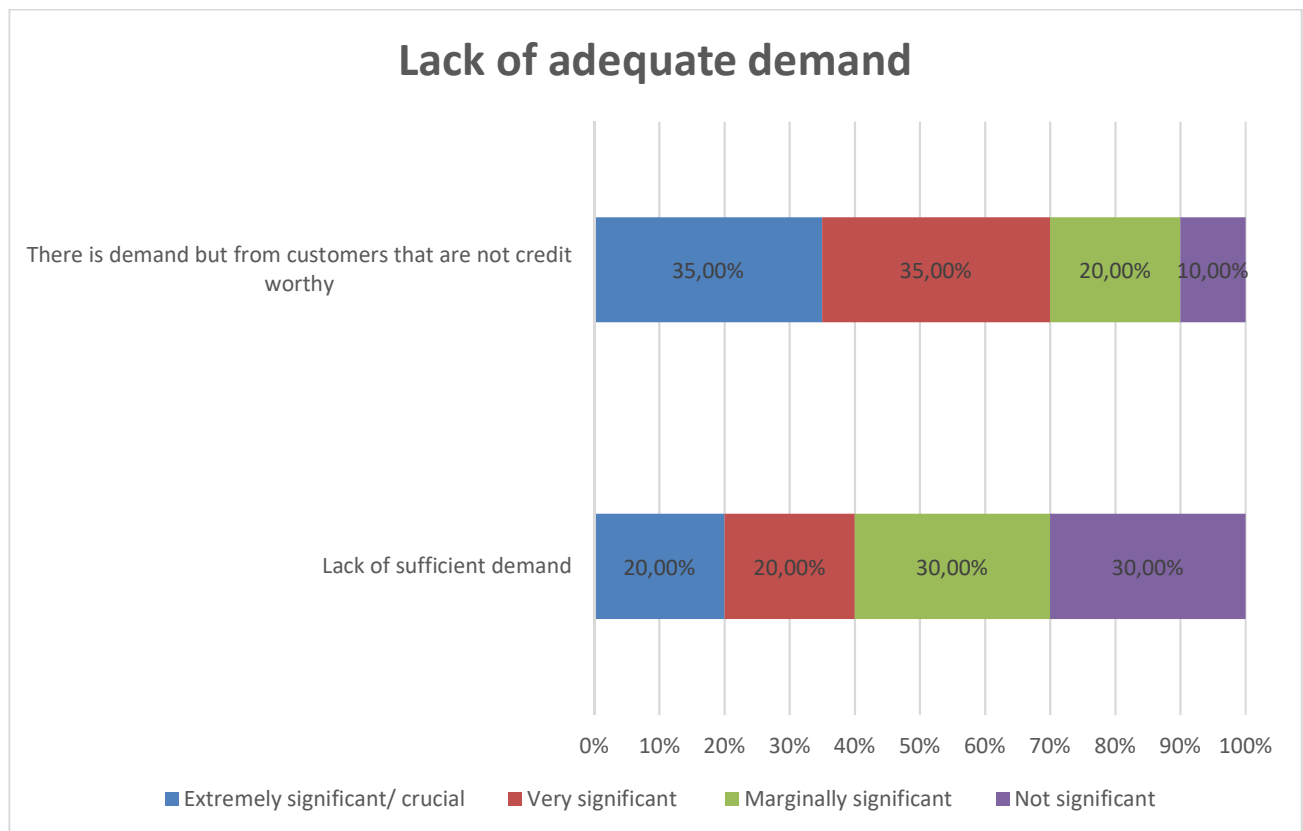


Figure 4.11. Lack of adequate demand

4.7 SECTION F: PROFITABILITY AND COST OF THE SMES FINANCING

When comparing the cost, risk and profitability of SMEs financing, 65% of the respondents found SMEs loans to be less than other varieties in terms of profitability. 55% of the respondents found SME loans to be riskier than others and 45% of the respondents found the loans to be costlier than other loans.

Profitability and cost of the SMEs financing

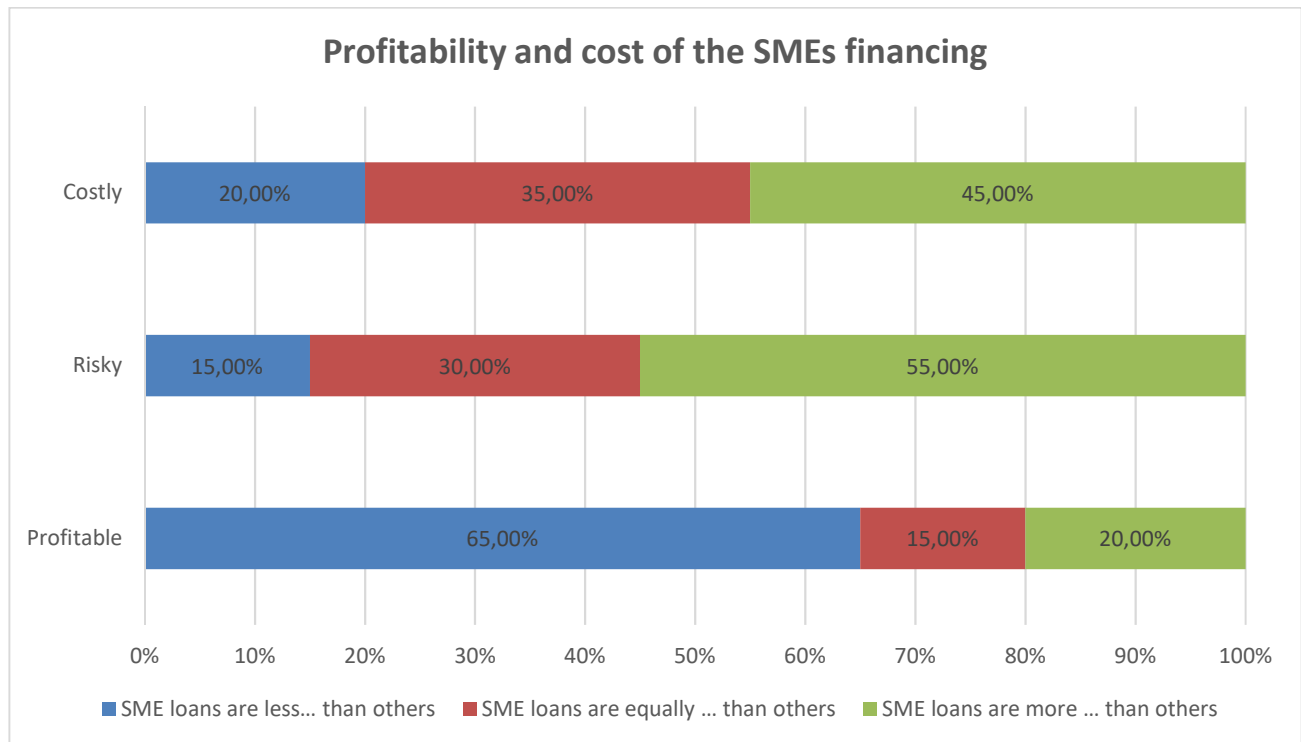


Figure 4.12. Profitability and cost of the SMEs financing

F4: Strategies employed by Land Bank to mitigate risks and costs of SME loans relative to those of other loans?

The respondents revealed that the bank uses the following strategies:

- Higher pricing and higher collateral
- The bank has a statutory pledge in terms of any inventory that is bought through the Land Bank funds. The bank takes a cession of the debtors plus any other additional asset security that a client can offer
- Tangible or fixed properties held as security
- Risk assessments
- Higher interest rates
- The bank keeps its business model simple.
- The bank offers post investment monitoring and mentorship

- Offers subsidies for the development SMEs
- Good credit history of the applicant. Cash investments to secure month instalments. Positive cash flow that is in line with the business finances. This will result in lower interest rate and the cost will therefore be lower.
- Use of efficient systems.

4.8 SECTION G: LAND BANK POLICIES AND PROCEDURES TO FINANCE SMES

It emerged from the data that 40% of non-performing loan recovery is only done at headquarters while 55% of decision-making is done either at headquarters or at branches. In terms of risk management, 65% of the decision-making is done both at headquarters and at branches while 25% of the decision-making is done only at headquarters. 80% of the decision-making is done only at headquarters while 5% is only done at branches in terms of loan approvals. In terms of the loan screening process, 40% of the process is done at both headquarters and branches. 35% of the decision-making is done only at the branch while 25% is only done at headquarters.

Land Bank Policies and Procedures of financing SMEs

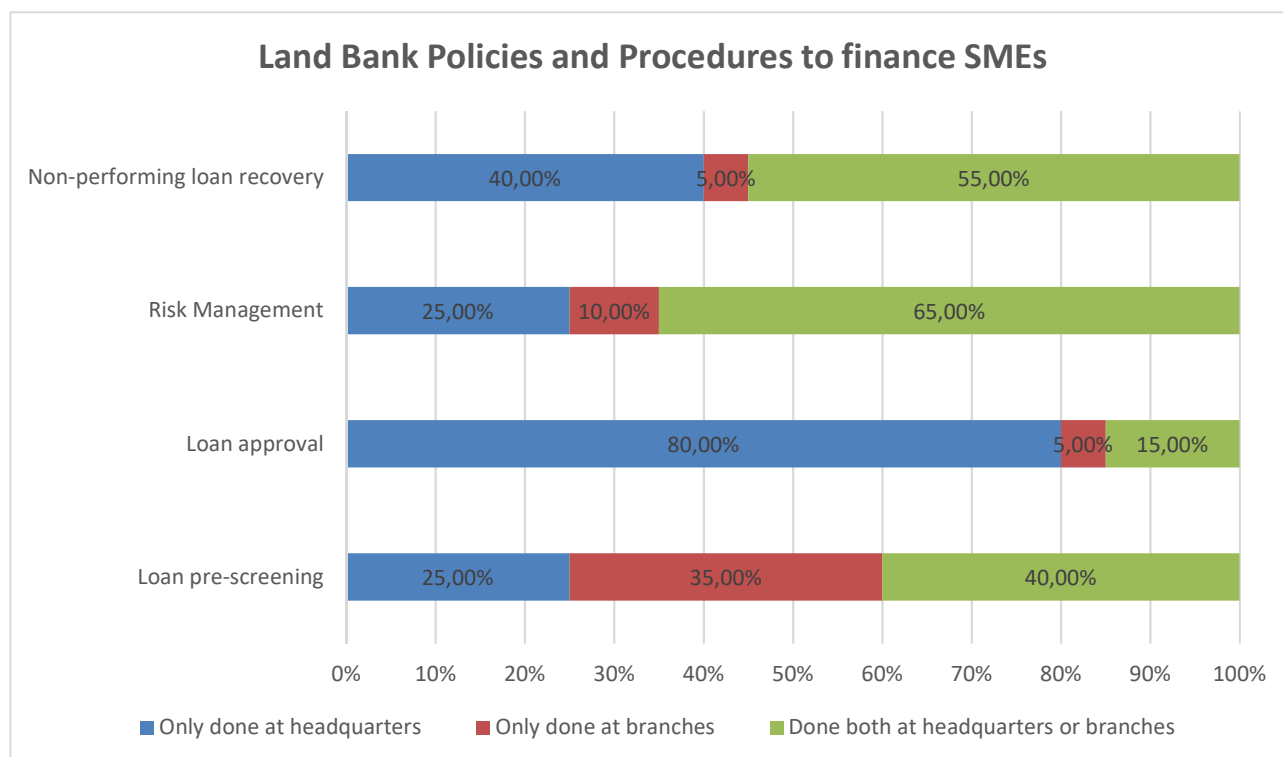


Figure 4.13. Land Bank Policies and Procedures of financing SMEs

4.8.1 CRITERIA THAT LAND BANK USES TO DETERMINE SMES IT WILL TARGET

The responses show that 40% of the respondents found credit quality extremely significant while 30% of the respondents found it very significant. When it comes to exposure size, 55% of the respondents found this aspect very significant while 30% of the respondents found it crucial. 40% of the respondents found the expanded profitability as a very significant aspect while 35% of the respondents found it extremely significant. 25% of the respondents found it marginally significant. In terms of product needs, 40% of the respondents found it marginally significant while 30% of the respondents found it very significant and the other 30% found it extremely significant.

In terms of the company size, 45% of the respondents found the company size as being marginally significant while 20% of the respondents found this aspect as very significant.

Criteria that the Land Bank uses to determine the SMEs it will target

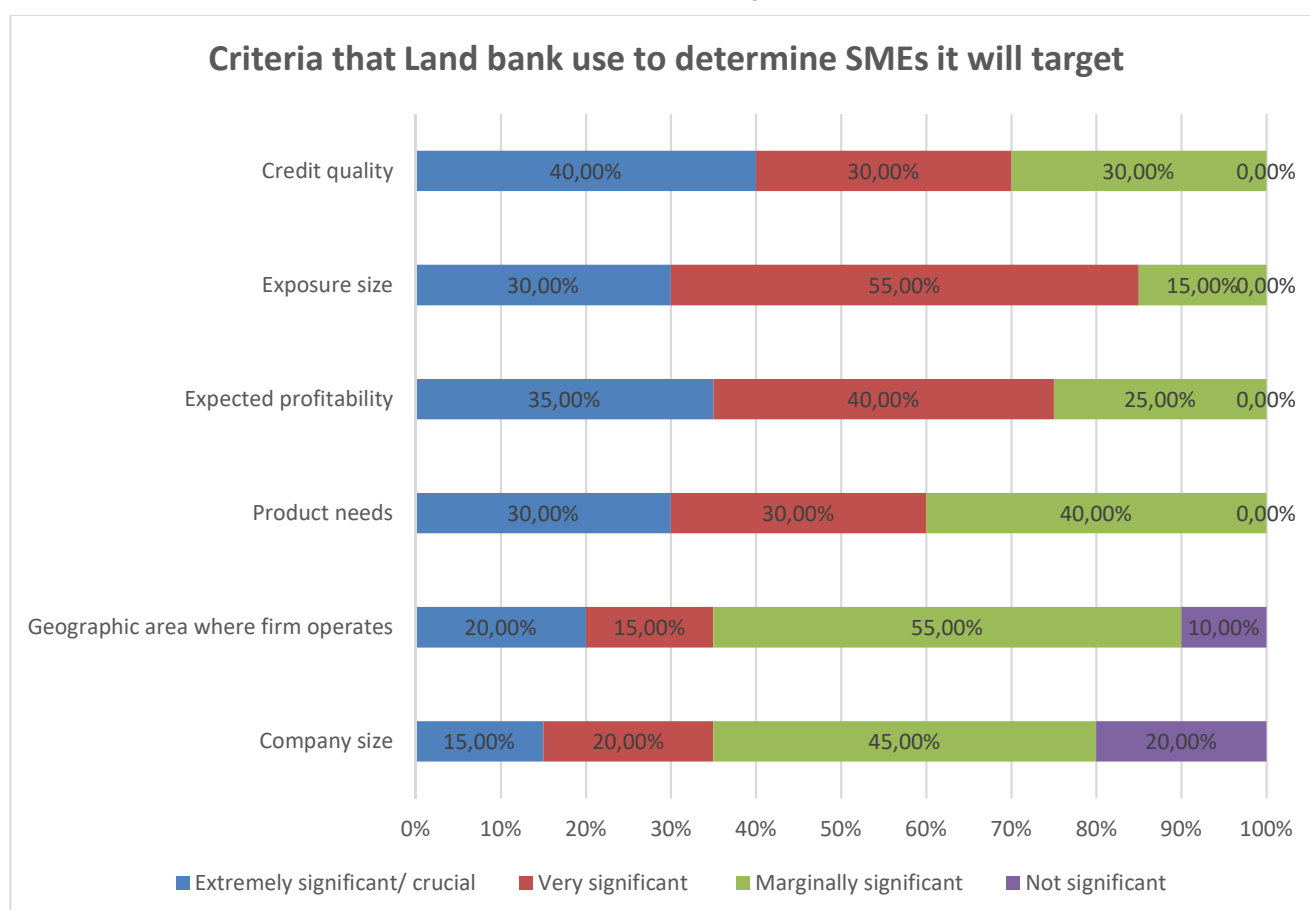


Figure 4.14. Criteria that the Land Bank uses to determine the SMEs it will target

4.8.2 POTENTIAL SME CLIENTS

20% of the respondents says that they identify potential SME clients by putting focus on attracting SMEs that are clients. 30% of potential clients are attracted by the bank credit and 20% is attracted by using information that emerges from existing firm databases.

Potential SMEs Clients

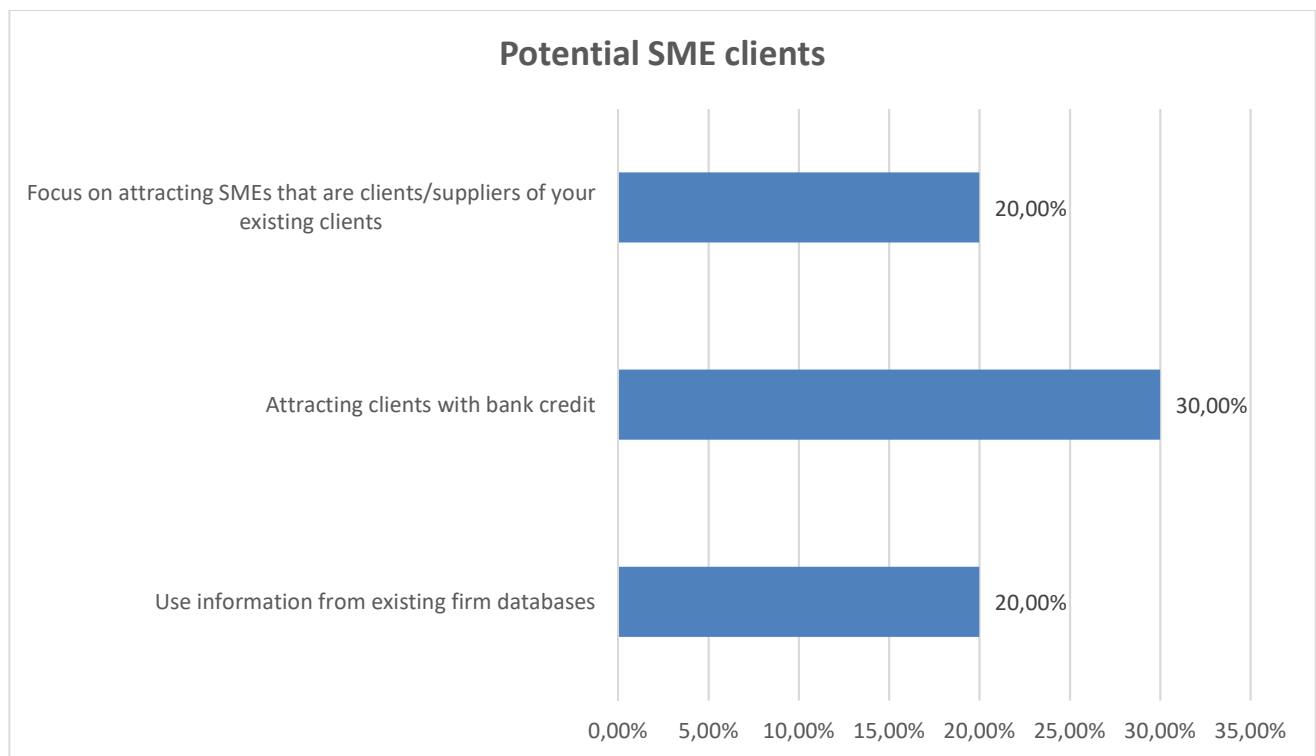


Figure 4.15. Potential SMEs Clients

4.9 SECTION H: CREDIT RISK MANAGEMENT FUNCTIONS

According to Bessie (2002), proper credit risk management in organizations has the capacity to enhance profit over a period of time. Based on the responses received, 10% of risk management is primarily done at branch level while 30% of risk management is done primarily at the bank headquarters. A credit risk analyst does 45% of risk management while 15% of risk management is largely automated. The other 15% of risk management is separated from sales.

Credit Risk Management functions in the Land Bank

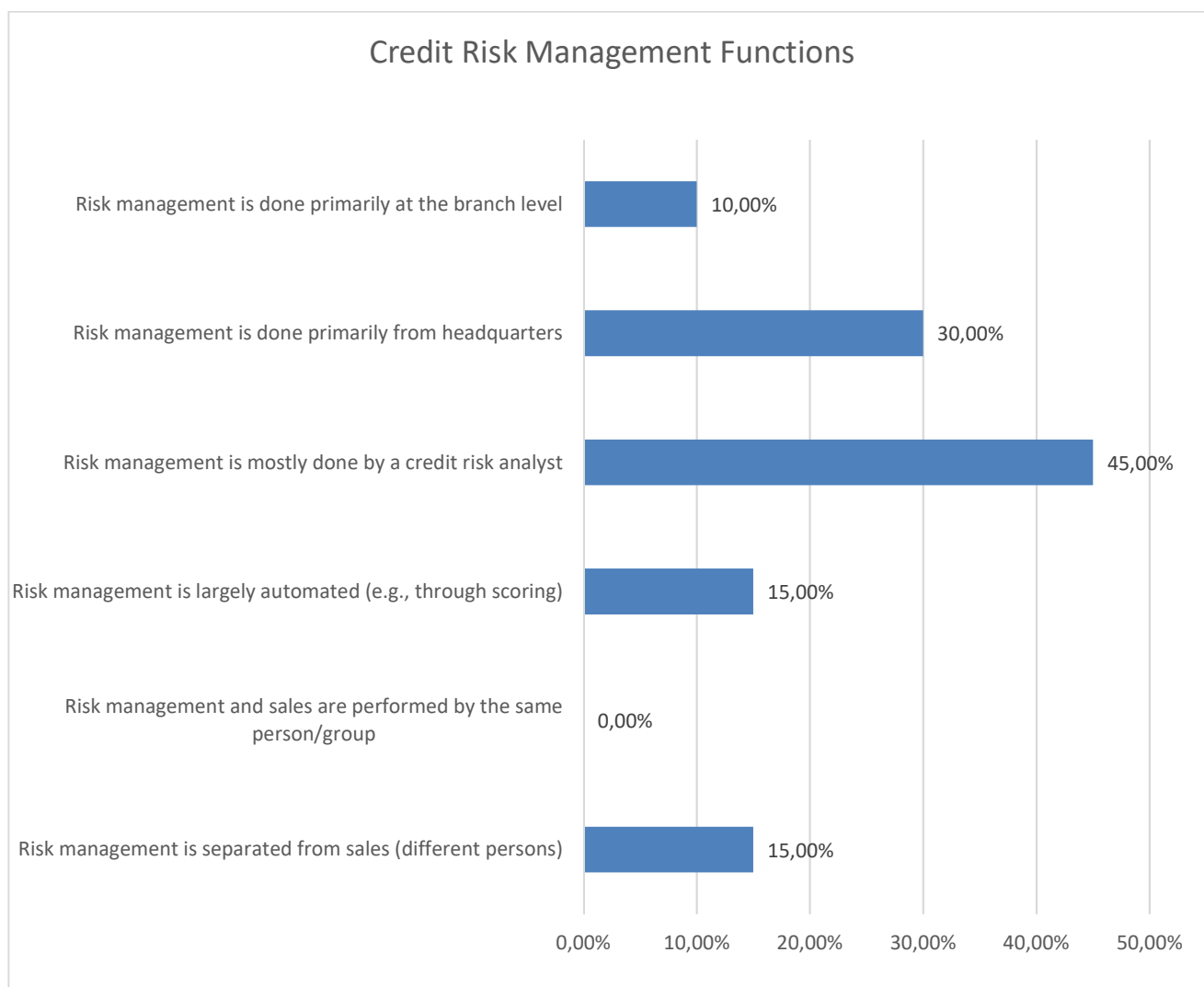


Figure 4.16. Credit Risk Management functions in the Land Bank

H2. What actions are taken in case of excesses in credit limits and by whom?

Clients are requested to adjust the excess within a specific time and this is done by Portfolio Management Services. The monitoring department evaluates the accounts to ensure that borrowers remain within their limits. According to the responses received, 60% of Land Bank use scoring models to select SMEs while 40% of the time, they do not use it.

Land Bank scoring models to select SMEs

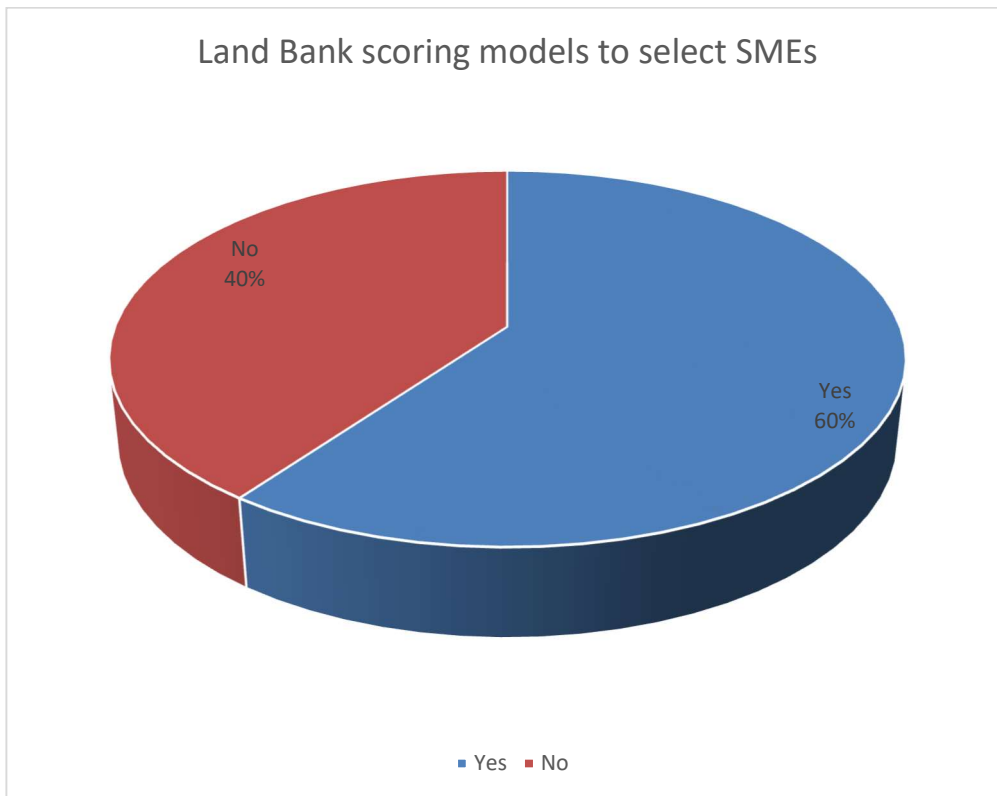


Figure 4.17. Land Bank scoring models to select SMEs

H4. The main variables in the scoring models used by the bank

The bank uses balance sheet, income statement, experience, qualifications, credit record and age in scoring a client's prospects of getting financed. The financial position is calculated on the bank Form 90 using all the applicant's information. The following variables are also considered:

- Borrower's credit history and BEE status
- Affordability and the debt ratio.
- Probability of Default Risk Rating

4.9.1 THE IMPORTANCE OF INFORMATION ABOUT THE SME COMPARED TO INFORMATION ABOUT SME OWNERS

On this item that considered the disparities in information, 10% of the respondents found the information on the firm to be less important than the information on the owner. 35% of the respondents found the information on the firm more important than the information on

the owner. 55% of the respondents found the information on the firm to be as equally important as information on the owner.

The importance of information about the SMEs compared to information about the SME's owner(s)

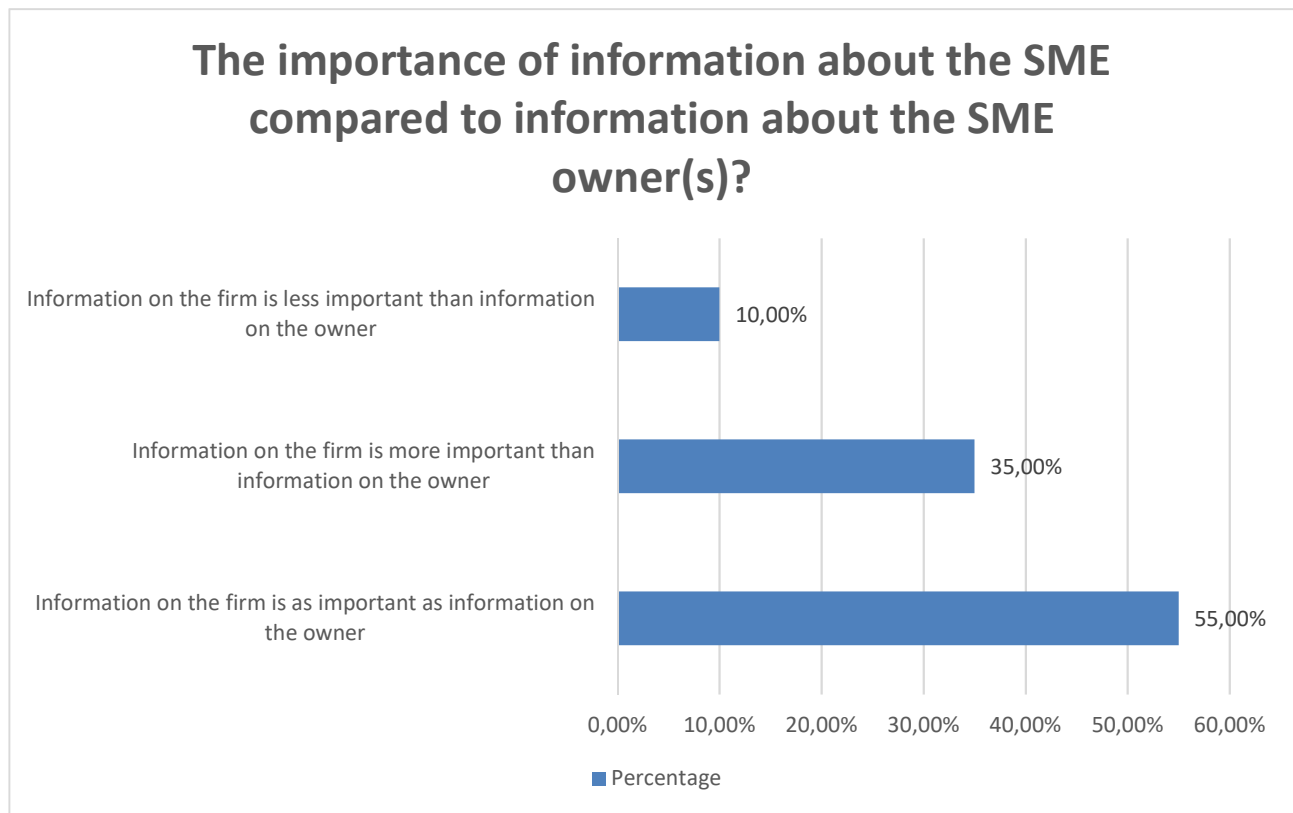


Figure 4.18. The importance of information about the SMEs compared to information about the SME's owner(s)

4.10 SECTION J: CREDIT APPRAISAL AND APPROVAL

According to Mandanda (2010), there are three models used for credit appraisal and these are: - Accounting based approach model, credit scoring model as well as survival based credit model.

4.10.1 COMMON REASONS FOR REJECTING A LOAN

There were diverse views offered with respect to reasons for rejecting a loan application, with 5% of the respondents convinced that lack of financial statements was one of the foremost reasons. Another 10% of the respondents found lack of adequate collateral as one of the common reasons for rejecting a loan application while 25% of the respondents thought that the financial standing of the borrower was one of the common reasons. 35% of the respondents found project feasibility as the most common reason for rejecting a loan application.

Most common reasons for rejecting a loan application

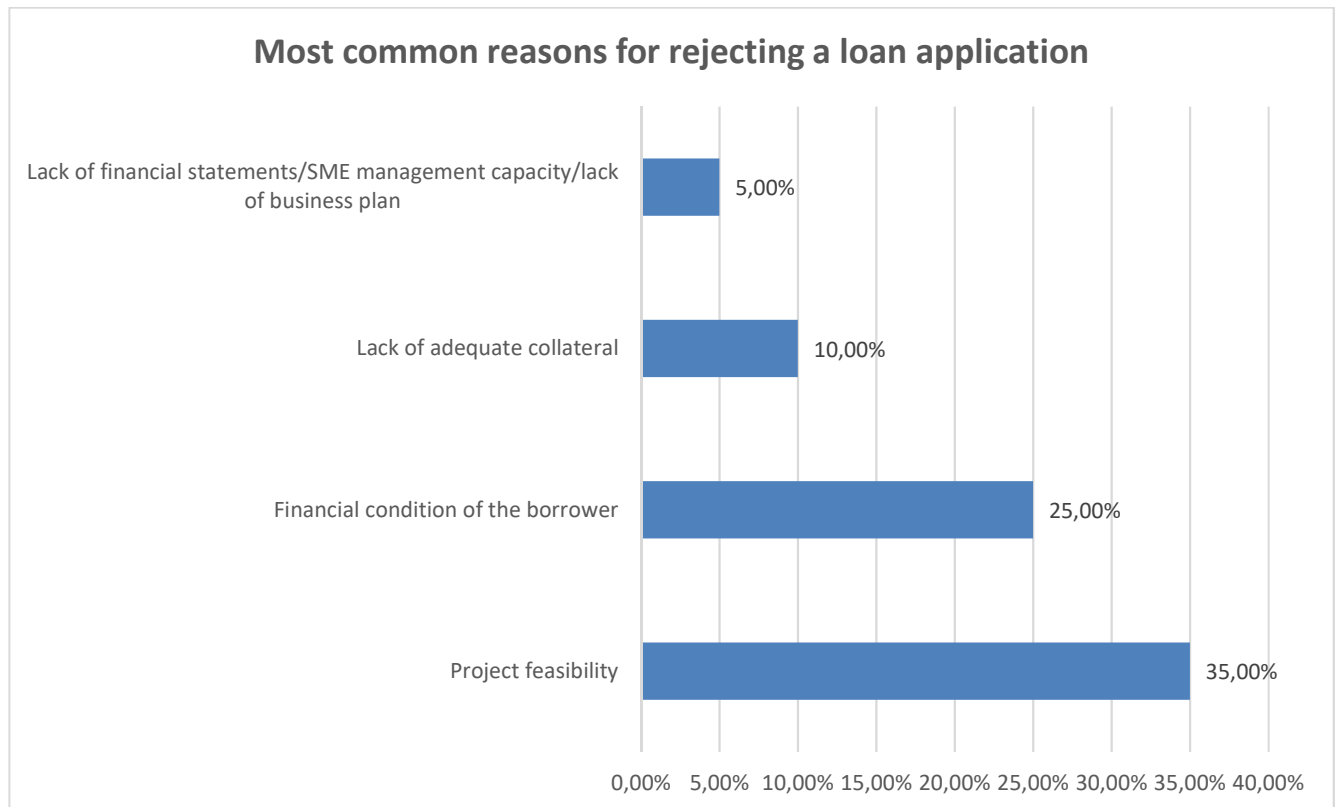


Figure 4.19. Most common reasons for rejecting a loan application

4.10.2 QUALITY OF FINANCIAL STATEMENTS PROVIDED BY SMES

According to Dhanuskodi (2006), credit appraisal is an exercise that starts from the receipt of an application and goes right through to credit extension and monitoring with the intention of managing risk within acceptable limits.

45% of the respondents found the quality of financial statements provided by SMEs to be low while 19% of the respondents found the statements not to be reliable. Only 21% of the respondents thought the quality was high. The main reason why the quality is low is due to the fact that knowledge of financial statements in SMEs is minimal or owners do not know much about aspects that improve the quality of financial statements.

Quality of SMEs financial statements

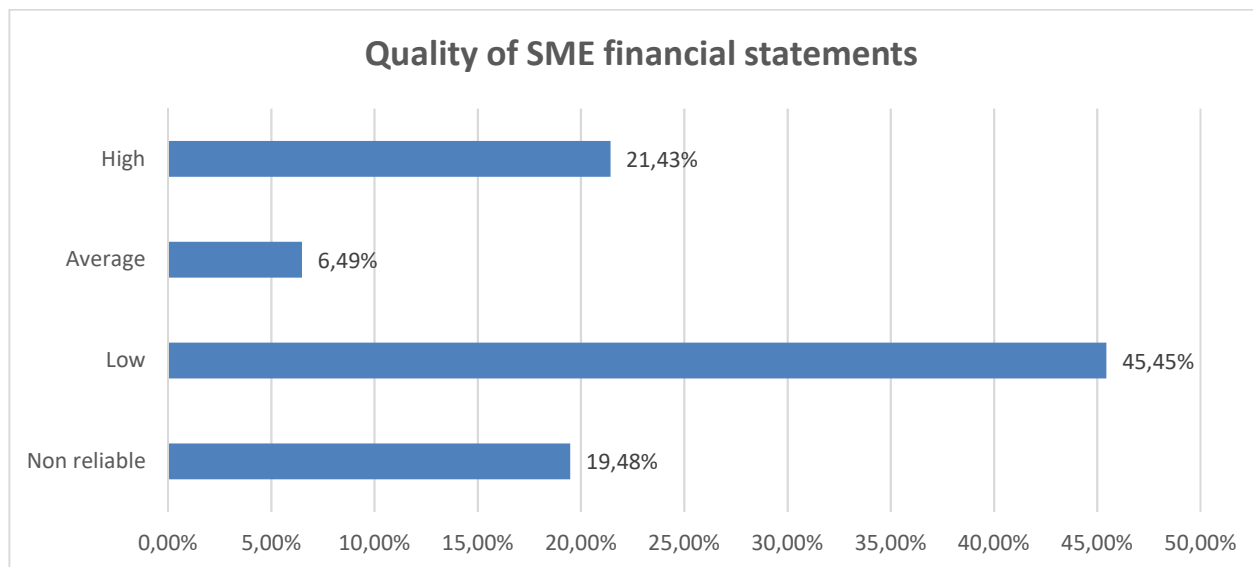


Figure 4.20. The quality of SME financial statements

4.10.3 QUALITY OF FINANCIAL DATA

45% of the respondents found the quality of financial data low and 15% of the respondents found it to be not reliable. 35% of the respondents found it to be of an average quality while only 5% of the respondents found it to be of high quality. According to the responses received, the average time for the review of financial data within the Land Bank is 1-4 weeks.

Quality of financial data (business plans, CF forecasts) provided by SMEs.

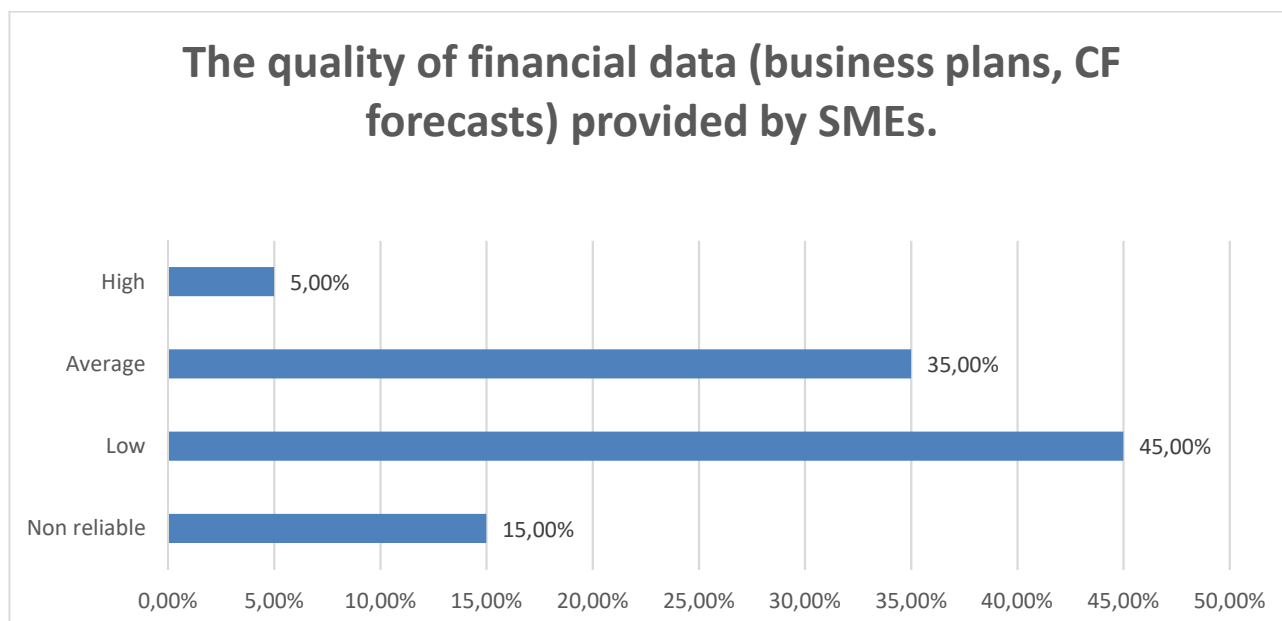


Figure 4.21. Quality of financial data (business plans, CF forecasts) provided by SMEs.

4.11 SECTION K: FACTORS HINDERING APPROVAL

45% of the respondents strongly agreed that poor cash flow projections stand out as the factors that hinder approval, while 40% of the respondents strongly agree. Only 10% of the respondents disagreed. With respect to poor financial records, 40% of the respondents agreed that this paucity in the quality of financial records played a significant role in hindering loan approval. 40% of the respondents strongly agreed in this regard. 45% of the respondents confirmed that the lack of financial literacy was one of the factors while 30% of the respondents strongly agreed in this regard.

Factors hindering approval of SMEs lending application

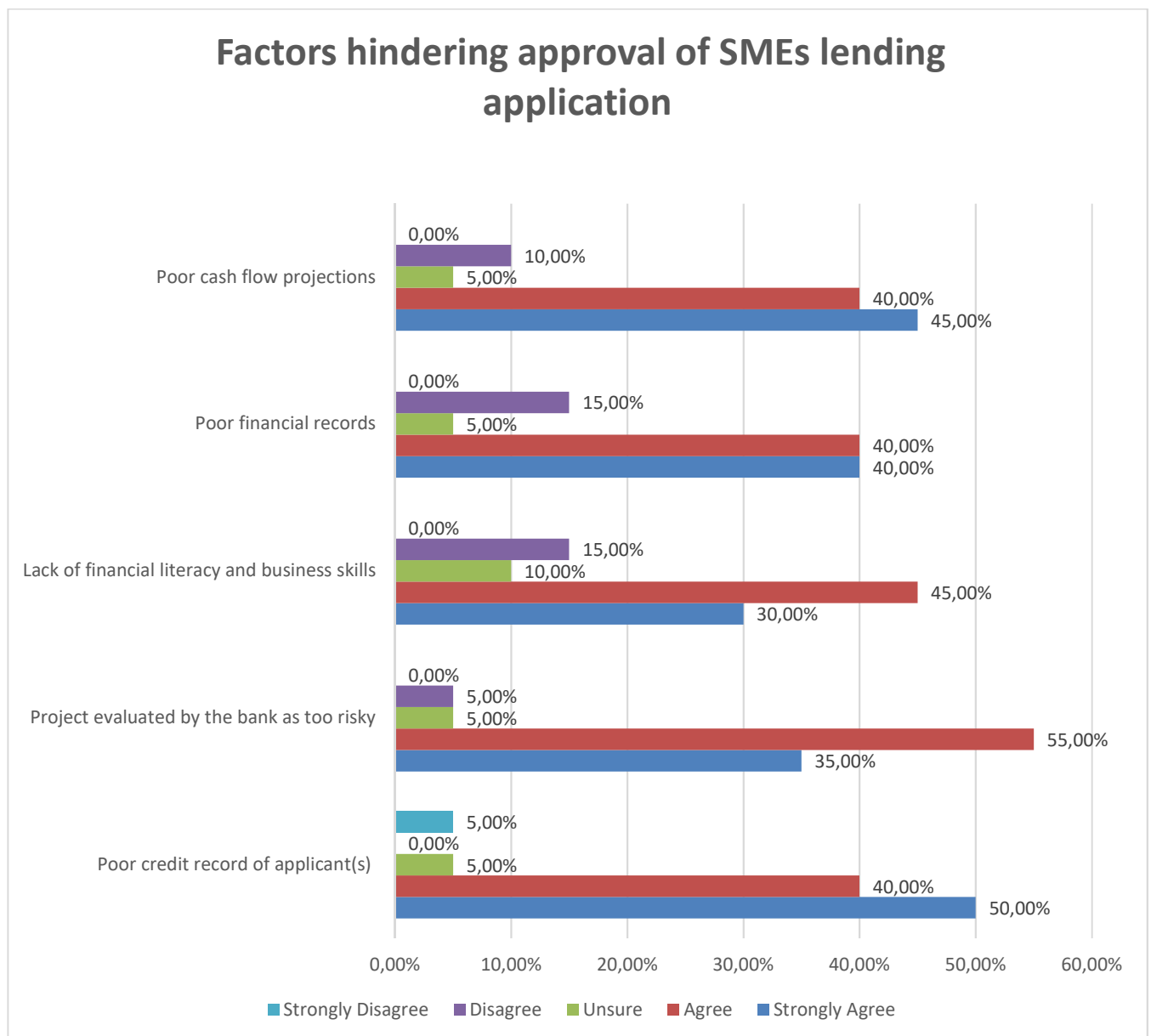


Figure 4.22. Factors hindering approval of SMEs lending application

The bank requires the SME's to present their projects for evaluation before financing. 55% of the respondents agreed that SMEs projects are too risky to be financed and supported by 35% of the respondents. 50% of the respondents strongly agreed that poor credit record of applicants played a major role as one of the factors that stopped approval by the bank. 40% of the respondents supported this by agreeing.

4.11.1 ASPECTS LEDDING TO THE REJECTION OF APPLICATION

On the aspects that led to the rejection of an application, 35% of the respondents found non-compliance as one of the aspects that led to the rejection of applications to a very large extent while 30% of the respondents found it responsible to a large extent. TransUnion (2018) revealed that 40% to 60% of SMEs in South Africa do not have access to credit due to data that is inconsistent across credit bureaus and this made it difficult for banks to assess the credit risk of SMEs.

According to the respondents, 55% of them found the inability to repay the loan as one of the reason why there was a rejection by the bank. Poor payment cycles and high spending by SMEs are often the cause of difficulties in maintaining a healthy cash flow (National Small Business Chamber, 2015).

40% of the respondents found this aspect about the poor credit record of applicants important to a large extent while 25% of the respondents found this important to a very large extent. 25% of the respondents found it important to some extent. According to Fatoki (2010), SMEs are unable to access loans from the banks due to lack of financial knowledge, collateral and a parlous credit history. SMEs lack credit history or do not have a successful credit record that banks could rely on in making investment decisions. 50% of the respondents found the lack of a comprehensive business plan as one of the aspects that led to the rejection of the applications to some extent while 20% of the respondents confirmed that it affected the rejection to a little extent.

Aspects led to the rejection of the application by the Land Bank

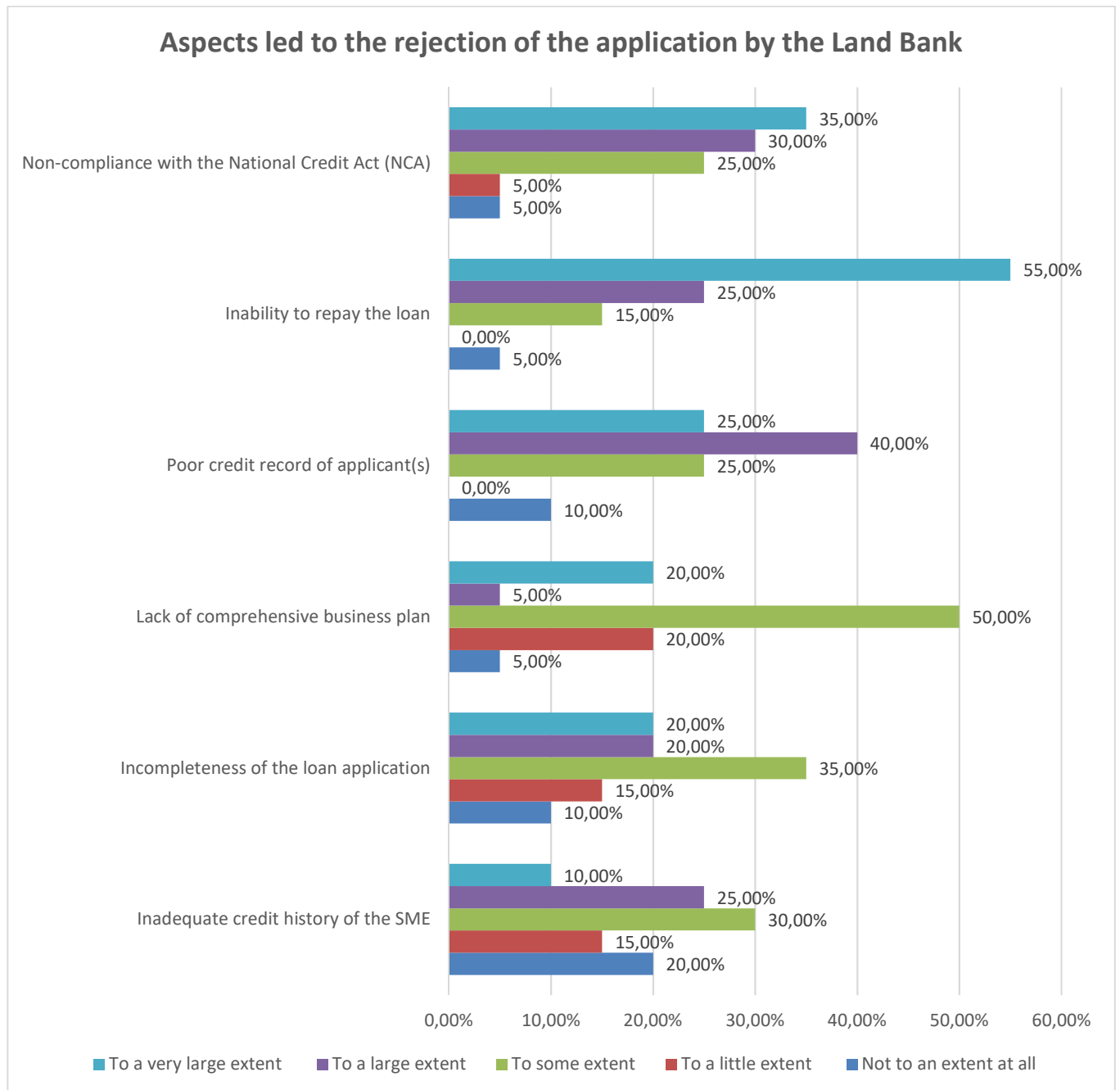


Figure 4.23. Aspects led to the rejection of the application by the Land Bank

According to the respondents, 20% of them thought that the incompleteness of the loan application was one of aspects that contributed to the rejection of applications to a very large extent, while 20% of the respondents believed it affected the decline to a large extent. 35% of the respondents believe it only affects the rejection to some extent. In terms of inadequate credit history of the SME, 30% of the respondents found that this facet plays a role to some extent while 25% of the respondents were convinced it plays a role to a

large extent. 20% of the respondents found this aspect one of many that led to the rejection of applications not to any extent at all.

4.12 RELIABILITY ANALYSIS

The reliability (internal consistency) of a questionnaire (survey) consisting of Likert-type scales and items is measured by Cronbach's alpha (α) reliability coefficient. Its numerical value ranges from 0 to 1. In this case a value (close to 1) for Cronbach's alpha reliability coefficient is considered high. This is an indication of good internal consistency of the items in the scale.

Table 4-2 Cronbach's alpha coefficients

Subscale	Cronbach's Alpha (α)	N of Items	Mean	Standard Deviation	Internal consistency
Section B	0.746	7	1.94	0.41	Acceptable
Section C*	0.799	3	1.94	0.36	Acceptable
Section D	0.956	11	2.66	0.45	Excellent
Section E	0.982	25	2.24	0.30	Excellent
Section F*	0.883	2	2.32	0.10	Good
Section G (G5 – G11)	0.957	6	2.17	0.37	Excellent
Section J* (J1 – J5)	0.931	2	1.75	0.07	Excellent
Section J* (J6 – J11)	0.772	5	3.48	0.54	Acceptable

*Some items (C4, F1, J3, J4, J5 and J9) were removed from these subscales in order to increase reliability coefficients, and therefore, they were no longer be considered in this study.

Referring to Table 4.2, the Cronbach's alpha coefficients are close to 1. This is a clear indication that participants responded consistently to the survey items and also that the questions measured what they were intended to.

4.13 SECTION B: DESCRIPTIVE STATISTICS

Section B: Please indicate the extent to which you consider the following attributes when making a decision to lend and set the terms of the loan contract.

Table 4-3 Section B: Descriptive statistics

Scale: 1 = strongly agree, 2 = agree, 3 = unsure, 4 = disagree, 5 = strongly disagree

	Objectivity Dimensions	Mean	Standard Deviation	N
B1	Strength of income statements	1.62	.850	100
B2	Strength of balance sheet	1.47	.784	100
B3	Small firms with long histories	2.65	1.242	100
B4	Quality of accounts receivable and inventory	2.02	1.082	100
B5	Credit scores	1.78	1.031	100
B6	Information from suppliers	2.29	1.149	100
B7	History of the principal owner.	1.75	.999	100
	Overall Mean and Standard Deviation	1.94	0.41	

The overall mean response value and standard deviation in Table 4.3 above are 1.94 and 0.41, respectively. Since the overall standard deviation (0.41) is closer to zero, then the response values are clustered more closely about the overall mean (1.94). These results show that the bank employees strongly consider the objectivity dimensions listed in Table 4.3 when appraising loan applications.

4.14 SECTION C: DESCRIPTIVE STATISTICS

Section C: Please indicate the extent to which you make use of the following credit appraisal techniques

Table 4-4 Section C: Descriptive statistics

Scale: 1 = strongly agree, 2 = agree, 3 = unsure, 4 = disagree, 5 = strongly disagree

	Appraisal Systems	Mean	Standard Deviation	N
C1	Relationship lending	2.27	1.100	100
C2	Financial statement lending	1.56	.499	100
C3	Small business credit scoring lending	2.00	1.054	100
	Overall Mean and Standard Deviation	1.94	0.36	

The overall mean response value and standard deviation in Table 4.4 above are 1.94 and 0.36, respectively. Since the overall standard deviation (0.36) is closer to zero, then the response values are clustered more closely about the overall mean (1.94). These results show that the bank employees strongly make use of the credit appraisal techniques listed in Table 4.4.

4.15 SECTION D: DESCRIPTIVE STATISTICS

Section D: Please indicate the extent to which the following challenges are faced by the banks when using the underlying appraisal technique

Table 4-5 Section D: Descriptive statistics

Scale: 1 = strongly agree, 2 = agree, 3 = unsure, 4 = disagree, 5 = strongly disagree

	Challenges	Mean	Standard Deviation	N
D1	Collection of soft information by credit officers is difficult	2.45	1.077	100
D2	The soft information may not be easily transmitted to other bank officials	2.42	1.075	100
D3	The soft information may not be easily verified by other bank officials	2.55	1.167	100
D4	Inaccurate financial statements	2.33	1.035	100
D5	Lack of proper financial statements	1.90	1.000	100
D6	Loan officer's interest to hide a deteriorating borrower's condition because of a personal friendship with the owner	3.25	1.226	100
D7	Emergence of illegal kickbacks	3.45	1.209	100
D8	Agency problems as a result of delegation of authority to loan officers in banks	2.95	1.123	100
D9	Non-disclosure of financial interest in the firm	2.55	1.123	100
D10	Presentation of fake real estate documents by the clients	3.02	1.119	100
D11	Lack of accurate credit scores	2.40	1.119	100
	Overall Mean and Standard Deviation	2.66	0.45	

The overall mean response value and standard deviation in Table 4.5 above are 2.66 and 0.45 respectively. Since the overall standard deviation (0.45) is closer to zero, then the response values are clustered more closely about the overall mean (2.66). These results show that the respondents tend to be not sure about the challenges faced by the banks when using the appraisal techniques mentioned in Table 4.5. Lack of proper financial statements ($M = 1.90$) appears to be the main challenge faced by the bank during the appraisal process.

4.16 SECTION E: DESCRIPTIVE STATISTICS

Section E: Please indicate to what degree the following factors are important obstacles in your exposure to SMEs

Table 4-6 (a) Individual obstacles

Scale: 1 = extremely significant/crucial, 2 = very significant, 3 = marginally significant, 4 = not significant

	Factor	Mean	Standard Deviation	N
E1	Small size of the SME sector	2.13	.895	100
E2	High interest rates	1.98	1.044	100
E3	Exchange rate risk	2.40	.921	100
E4	Macroeconomic instability	2.15	.914	100
E5	Contract enforcement	2.21	.820	100
E6	Bankruptcy regime	2.10	1.000	100
E7	Judicial efficiency	2.55	.978	100
E8	Collateral law	2.05	1.077	100
E9	Lack of interest at the highest level of the bank	2.90	.948	100
E10	Lack of expertise in the segment	2.50	1.124	100
E11	Limited of geographic coverage within country (number of branches, rural presence),	2.45	1.250	100
E12	Bank size	2.70	1.150	100
E13	Inability to diversify risk across borrowers	2.20	.932	100
E14	Lack of appropriate information technology tools (scoring models, rating models)	2.20	.985	100

	Factor	Mean	Standard Deviation	N
E15	Difficulty in designing product matching segment needs	2.34	1.056	100
E16	Poor quality of financial statements	1.60	.804	100
E17	Inability of SMEs to manage risk, informality	1.95	.672	100
E18	Inability to prosecute owner in case of default	2.25	.947	100
E19	Lack of adequate collateral	1.60	.865	100
E20	High entry cost	2.20	.932	100
E21	High fixed costs per transaction (relative to loan size)	2.15	.914	100
E22	Difficulty in standardizing products and procedures (screening, origination, monitoring, risk management)	2.20	.932	100
E23	Difficulty in attaining scale economies	2.35	.914	100
E24	Lack of sufficient demand	2.70	1.106	100
E25	There is demand but from customers that are not credit worthy	2.05	.978	100
	Overall Mean and Standard Deviation	2.24	0.30	

The overall mean response value and standard deviation in Table 4.6(a) above are 2.24 and 0.30 respectively. Since the overall standard deviation (0.30) is closer to zero, then the response values are clustered more closely about the overall mean (2.24). These results show that the respondents tend to rate the factors listed in Table 4.6(a) as very significant obstacles to exposure to SMEs. The main obstacles appear to be high interest rates ($M = 1.98$), poor quality of financial statements, inability of SMEs to manage risk, informality ($M = 1.95$) and lack of adequate collateral ($M = 1.60$).

Table 4-7 (b): Summary of obstacles

Factor	Mean	Standard Deviation	N
Macroeconomic factors (E1 – E4)	2.17	0.17	4
Legal and contractual environment factors (E5 – E8)	2.22	0.23	4
Bank specific factors (E9 – E15)	2.47	0.26	7
SME-specific factors (E16 – E19)	1.85	0.31	4
Nature of the lending technology to SMEs (E20 – E23)	2.23	0.09	4
Lack of adequate demand (E24 – E25)	2.38	0.46	2

Table 4.7(b) shows that SME-specific factors (M = 1.85) are important obstacles in terms of risk exposure to SMEs.

4.17 SECTION F: DESCRIPTIVE STATISTICS

Section F: Please provide your assessment of the risk, profitability and cost of the SME financing relative to the other loans of your bank.

Table 4-8: Risk and costs

Scale: 1 = SME loans are less... than others, 2 = SME loans are equally ... than others, 3 = SME loans are more ... than others

		Mean	Standard Deviation	N
F2	Risky	2.39	.751	100
F3	Costly	2.25	.770	100
	Overall Mean and Standard Deviation	2.32	0.10	

The overall mean response value and standard deviation in Table 4.8 above are 2.32 and 0.10 respectively. Since the overall standard deviation (0.10) is closer to zero, then the response values are clustered more closely about the overall mean (2.32). The perceptions of respondents indicate that the SME loans are equal in terms of risk and cost.

4.18 SECTION G: DESCRIPTIVE STATISTICS

Section G: Bank Policies and Procedures to finance SMEs and reduce the associated costs

Table 4-9 : Which criteria does the bank use to determine the SMEs it will target?

Scale: 1 = extremely significant/crucial, 2 = very significant, 3 = marginally significant, 4 = not significant

		Mean	Standard Deviation	N
G5	Company size	2.71	.957	100
G6	Geographic area where firm operates	2.56	.935	100
G7	Product needs	2.10	.835	100
G8	Expected profitability	1.91	.780	100
G9	Exposure size	1.85	.657	100
G10	Credit quality	1.90	.835	100
	Overall Mean and Standard Deviation	2.17	0.37	

The overall mean response value and standard deviation in Table 4.9 above are 2.17 and 0.37, respectively. Since the overall standard deviation (0.37) is closer to zero, then the response values are clustered more closely about the overall mean (2.17). The perceptions of respondents indicate that the criteria listed in Table 4.9 are very significant in targeting the SMEs, especially expected profitability (M = 1.91), exposure size (M = 1.85) and credit quality (M = 1.90).

4.19 SECTION J: CREDIT PROFILE OF SMES IN SOUTH AFRICA.

Table 4-10 (a): Factors hindering approval of SME lending application

Scale: 1 = strongly agree, 2 = agree, 3 = unsure, 4 = disagree, 5 = strongly disagree

	Factor	Mean	Standard Deviation	N
J1	Poor credit record of applicant(s)	1.70	.959	100
J2	Project evaluated by the bank as too risky	1.80	.752	100
	Overall Mean and Standard Deviation	1.75	0.07	

The overall mean response value and standard deviation in Table 4.10(a) above are 1.75 and 0.07, respectively. Since the overall standard deviation (0.07) is quite close to zero, then the response values are clustered more closely about the overall mean (1.75). These results show that the respondents strongly agree that the factors mentioned in Table 4.10(a) hinder approval of SME lending application.

Table 4-11 (b): If loan application was rejected, to what extent do you think the following aspects led to the rejection of application by the bank?

Scale: 1 = not to an extent at all, 2 = to a little extent, 3 = to some extent, 4 = to a large extent, 5 = to a very large extent

	Aspect	Mean	Standard Deviation	N
J6	Inadequate credit history of the SME	2.92	1.259	99
J7	Incompleteness of the loan application	3.26	1.234	99
J8	Lack of comprehensive business plan	3.15	1.119	99
J10	Inability to repay the loan	4.25	1.043	99
J11	Non-compliance with the National Credit Act (NCA)	3.83	1.125	99
	Overall Mean and Standard Deviation	3.48	0.54	

The overall mean response value and standard deviation in Table 4.11(b) above are 3.48 and 0.54, respectively. Since the overall standard deviation (0.54) is slightly around the median, then the response values are clustered more closely about the overall mean (3.48). The perceptions of respondents show that the aspects in Table 4.11(b), to some extent, led to the rejection of the loan application by the bank. Inability to repay the loan (M = 4.25) seems to be the main reason for the rejection by the bank of the loan application.

4.20 CORRELATION ANALYSIS

4.20.1 SPEARMAN'S RANK RHO TEST

This test measures the correlation between two ranked variables (X and Y). It actually indicates the positive or negative strength of the relationship. A p-value of less than 0.05 level of significance denotes a relationship that is statistically significant.

The coefficient of Spearman's rank correlation is denoted by

$$r = 1 - \frac{6\sum D^2}{N(N^2 - 1)}$$

where

D = differences of ranks of corresponding values of X and Y

N = number of paired values in the data

$$-1 \leq r \leq 1$$

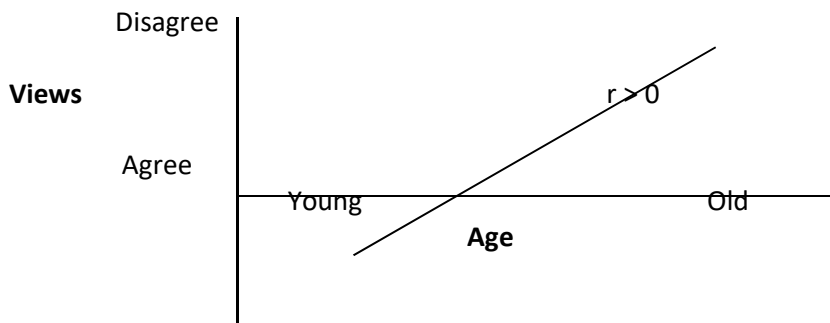
Table 4-12: Spearman's rank correlation between age group and perceptions of respondents concerning repayment of loans by SMEs

Items		
Extent to which attributes are considered when granting a loan (N = 100) (Section B)	Correlation coefficient(r)	0.503*
	p – value	0.000
Extent to which credit appraisal techniques are used (N = 100) (Section C)	Correlation coefficient(r)	0.503*
	p – value	0.000
Extent to which challenges are faced by the bank when using the underlying appraisal technique (N =100) (Section D)	Correlation coefficient(r)	0.552*
	p – value	0.000
Important obstacles to the exposure of bank employee to SMEs (N = 100) (Section E)	Correlation coefficient(r)	0.518*
	p – value	0.000
Assessment of the risk, profitability and cost of the SMEs financing relative to the other loans of your bank (N =100) (Section F)	Correlation coefficient(r)	0.495*
	p – value	0.000
Criteria used by the bank to target the small enterprises(SEs) and medium enterprises (MEs) (N = 100) (Section G – Part 2)	Correlation coefficient(r)	0.417*
	p – value	0.000
Factors hindering approval of SME lending application (N = 100) (Section J – Part 1)	Correlation coefficient(r)	0.447*
	p – value	0.000
Aspects that lead to the rejection of the loan application by the bank (Section J – Part 2)	Correlation coefficient(r)	0.224*
	p – value	0.025

*Correlation is significant at the 0.05 level of significance

The correlation analysis was done using SPSS 25 software package and, the results are shown in Table 4.12. The results show that there is a significant relationship between age group and views of respondents about the repayment of loans. This is evidenced by p-values of less than 0.05 level of significance. In this case older respondents tend to disagree with the listed items (sections B, C, D, E, G and J- Part 1), unlike younger respondents as implied by the positive correlation coefficients (see Figure 4.24 below to justify this research finding).

Figure 4.24. Views of respondents versus age ($r > 0$)



Older respondents think that SME loans are more risky and costly than others (section F), whereas younger employees tend to disagree.

Older respondents tend to agree with the listed items (section J – Part 2), whereas younger employees tend to disagree.

Table 4-13: Spearman's rank correlation between educational qualification and perceptions of bank employees concerning repayment of loans by SMEs

Items		
Extent to which attributes are considered when granting a loan (N = 100) (Section B)	Correlation coefficient(r)	0.088
	p - value	0.383
Extent to which credit appraisal techniques are used (N = 100) (Section C)	Correlation coefficient(r)	0.066
	p - value	0.515
Extent to which challenges are faced by the bank when using the underlying appraisal technique (N =100) (Section D)	Correlation coefficient(r)	0.165
	p - value	0.101
Important obstacles on the exposure of bank employee to SMEs (N = 100) (Section E)	Correlation coefficient(r)	0.119
	p - value	0.239
Assessment of the risk, profitability and cost of the SME financing relative to the other loans of your bank (N =100) (Section F)	Correlation coefficient(r)	0.227*
	p - value	0.023
Criteria used by the bank to target the SMEs (N = 100) (Section G – Part 2)	Correlation coefficient(r)	0.142
	p - value	0.157
Factors hindering approval of SME lending application (N = 100) (Section J – Part 1)	Correlation coefficient(r)	0.071
	p - value	0.484
Aspects that lead to the rejection of the loan application by the bank (Section J – Part 2)	Correlation coefficient(r)	0.001
	p - value	0.992

*Correlation is significant at the 0.05 level of significance

Table 4.13 shows that there is a significant correlation between educational qualification and views of respondents about the repayment of loans in terms of the assessment of risk, profitability and cost of the SMEs financing relative to the other loans of Land Bank ($r = 0.227$, $p < 0.05$ level). Since the correlation coefficient is positive ($r > 0$), it means that more educated respondents think that SMEs loans are more risky and costly than others (section F), whereas less educated respondents tend to disagree.

Table 4-14: Spearman's rank correlation between job experience in the bank and views (perceptions) of respondents concerning repayment of loans by SMEs

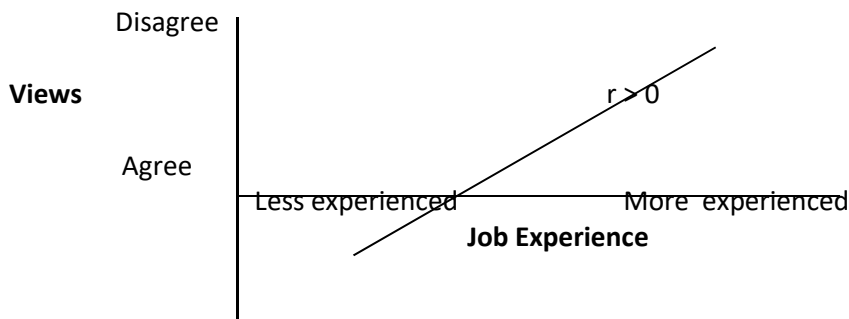
Items		
Extent to which attributes are considered when granting a loan (N = 100) (Section B)	Correlation coefficient(r)	0.636*
	p - value	0.000
Extent to which credit appraisal techniques are used (N = 100) (Section C)	Correlation coefficient(r)	0.528*
	p - value	0.000
Extent to which challenges are faced by the bank when using the underlying appraisal technique (N =100) (Section D)	Correlation coefficient(r)	0.704*
	p - value	0.000
Important obstacles to the exposure of bank employee to SMEs (N = 100) (Section E)	Correlation coefficient(r)	0.677*
	p - value	0.000
Assessment of the risk, profitability and cost of the SME financing relative to the other loans of your bank (N =100) (Section F)	Correlation coefficient(r)	0.575*
	p - value	0.000
Criteria used by the bank to target the SMEs (N = 100) (Section G – Part 2)	Correlation coefficient(r)	0.650*
	p - value	0.000
Factors hindering approval of SMEs lending application (N = 100) (Section J – Part 1)	Correlation coefficient(r)	0.500*
	p - value	0.000
Aspects that lead to the rejection of the loan application by the bank (Section J – Part 2)	Correlation coefficient(r)	0.134
	p - value	0.184

*Correlation is significant at the 0.05 level of significance

Since all the p-values are less than 0.05 level of significance (except for section J – Part 2), there is a significant relationship between job experience in the bank and views of respondents about the repayment of loans. As denoted by the positive correlation coefficients, more experienced respondents tend to disagree (sections B, C, D, E, G and

J- Part 1), unlike their experienced counterparts (see Figure 4.25 below to justify this research finding).

Figure 4.25. Views of respondents versus job experience ($r > 0$)



More experienced respondents think that SME loans are more risky and costly than others (section F), whereas less experienced respondents tend to disagree.

4.21 CONCLUSION

The aim of this chapter was to present, interpret and analyse the data collected from Land Bank employees who work in the credit division and Land Bank customers who applied for loans that were either rejected or approved. The data presented in this chapter was collected through questionnaires, interviewing and reviewing of Land Bank documents. Statistical tool SPSS was used to analyse the data. Cronbach's alpha was derived to measure of internal consistency in the survey questions and thereby determine if the scale is reliable while correlation coefficient was done using Spearman's rank. In the following chapter, Chapter 5, the study makes recommendations based on the discussion proffered in Chapter 4 of the study.

5 CHAPTER 5: DISCUSSION, CONCLUSIONS AND RECOMMENDATIONS

5.1 INTRODUCTION

This chapter deals with the final part of the study which is made up of a summary, discussions, challenges, conclusions and possible recommendations. The chapter also gives a synopsis of the research questions, methodology and research findings.

5.2 SUMMARY

The purpose of the study was to explore the credit appraisal system applied by Land Bank in extending credit to small and medium enterprises in the agricultural sector. As noted by the Financial Services Regulatory Task Group (2007), there are multiple limitations with regards access to finance by SMEs. This prompted the researcher to pose the following research questions: What criteria is used to identify non-performing loans by the Land Bank? To what extent does the credit profile of SMEs fit in with the credit appraisal system of the Land Bank? What are the reasons for poor credit extension to agricultural SMEs at Land Bank? What credit appraisal techniques are used to minimize credit risk exposure at Land Bank? What are the causes of non-performing loans at Land Bank? What should be done to improve the credit appraisal system of Land Bank?

The study adopted a mixed method research design which focused on Land Bank employees who are in the credit department and the SMEs in agricultural sector, mainly farmers who applied for credit in the Land Bank, either approved or declined. The staff members selected worked in the Credit Department, Customer Advisers, Operations Department and the managers of these divisions. Data collection was done using structured questionnaires. The questionnaires were derived from the research questions operationalised in the study. It comprised both close-ended and open ended questions. Data analysis was done using descriptive statistics in the form of tables, charts, graphs, percentages and frequencies. Statistical Package for the Social Scientist (SPSS version 20) was used to further refine the data.

The research results show that bank employees make use of the following credit appraisal techniques: relationship lending, financial statements lending and small business credit scoring lending. However, it was noted that the financial statement technique was the most

preferred credit appraisal technique as it seemed more familiar with respondents than the other techniques. Even though this technique is familiar, the bank faces a challenge when SMEs fail to provide proper financial statements. With regards non-performing loans, recovery of the loans is mainly done at headquarters. At least 80% of the decision making process is done at head office. The results show that bank employees strongly consider the objectivity dimensions (strength of income statements, strength of balance sheet, small firms with long histories, quality of accounts receivable and inventory, credit scores, information from suppliers, history of the principal owner) when making a decision to lend or not and set terms of the contract. It was noted that most of the loan applications were rejected on the basis of lack of financial statements, inadequate collateral and dubious project feasibility.

5.2.1 THE CAUSES OF NON-PERFORMING LOANS AT LAND BANK

Information gathered from the questionnaires shows that 60% of respondents agreed that lack of accurate credit scores is one of the challenges faced by Land Bank. As highlighted earlier, the wide disparity between the bank's requirements and SMEs' management and accounting practices resulted in the bank not having suitable credit scoring mechanisms, thus resulting in poor credit extension that ultimately leads to non-performing loans.

In some cases SMEs present fake real estate documents. Only 5% of respondents strongly agreed to this. This has been a major concern for the Land Bank as it seriously affects credit appraisal. In addition, non-disclosure of financial interests in the firm was stated as one of the challenges faced by banks when using the credit appraisal technique. The tendency of firms hiding their financial interests has a dire negative impact on the credit appraisal process as well as the decision-making thereof. Another cause of non-performing loans which was not adequately supported by respondents was the non-disclosure of deteriorating borrowers' condition due to personal friendships. Since most of these respondents were bank employees, there was no way they could agree to the fact that they are involved in corrupt activities when granting loans to borrowers. It is also important to note that securing proper financial statements from SMEs has been the greatest challenge faced by banks as revealed by the responses to the questionnaires. Most of the financial information could not be easily verified by the bank officials. Such information asymmetry and opacity is more pervasive in developing countries, especially

among the resource base poor (Giancarlo, 2012). However, it should be realized that the quality and terms of credit contracts vary depending on the creditworthiness of borrowers. There is always a challenge of information asymmetry because the lending activities tend to be transactions intensive (James, 2011). The study also revealed the existence of a direct correlation between interest rates and loan default. It has been noted that as interest rates on loans increase, the rate of non-performing loans also increases.

In terms of identifying non-performing loans, the findings reveal that Land Bank uses a centralized system where at least 50% of non-performing loans is identified and recovered at head office. This is a very important aspect of risk management as it reduces variability in instances where loan officers are allowed to exercise their discretion in granting credit.

5.2.2 EXTENT TO WHICH CREDIT PROFILES OF SMES FIT IN WITH THE CREDIT APPRAISAL SYSTEM OF LAND BANK

The research findings corroborate Giancarlo (2012), whose observations showed that interest rates have a direct relationship with credit accessibility. Land Bank's credit appraisal fits very well with the credit profile of SMEs. As revealed by TransUnion (2018), 40% to 60% of SMEs in South Africa do not have access to credit due to data that is inconsistent across credit bureaus and thus make it difficult for banks to objectively assess the credit risk of SMEs. SMEs in South Africa face a number of challenges, including lack of funding, insufficient cash flow, poor sales as well as competition from large businesses.

Therefore, the credit appraisal systems by Land Bank tend to be subjective in nature depending on the business project for which finance is required. As indicated earlier, Land bank uses relationship lending, financial statements lending and small business credit scoring lending. Therefore, the Land Bank tries to apply a credit appraisal technique applicable to a particular borrower. However, it should be noted that in order for Land Bank to acquire adequate information about the borrowers high transaction costs are incurred. It is in light of this and other conditions that changes in interest rates affect the quality of the loan agreement and bank's expected returns.

In most cases micro enterprises tend to be excluded from the formal credit market due to poor collateral base, but in some cases they might have a good asset base with no property rights, thus reducing the collateral value of such assets. As noted by Claessens

(2013), some SMEs shun seeking credit from formal markets because of their little knowledge on debt management and borrowing costs, bad previous experiences credit providers and cultural norms that discourage borrowing.

5.2.3 THE REASONS FOR POOR CREDIT EXTENSION TO AGRICULTURAL SMES AT LAND BANK

Access to finance by SMEs has been an issue repeatedly raised by many researchers (ZimTrade, 2011) as a major constraint to economic growth. The inability of SMEs to provide adequate collateral has been cited as the main reason for poor credit extension to agricultural SMEs by Land Bank. The majority of respondents (60%) found lack of adequate collateral as a crucial aspect in the SMEs sector credit granting. This can be linked to the current land ownership system and transfer regulations that clearly deter and to some extent limit access to formal credit. In the case of South Africa, most small scale farmers do not have legal title to their usable land and as such have limited amount of real estate that could be pledged as collateral. But, in most cases where lease or title is clear, the finalization of mortgages is prolonged due to transfer regulations that ultimately hinder timely access to borrowed capital. Banks are ready to meet SMEs' demand for credit finance as long as collateral is available. In case of default, banks can have fall back on to offset losses.

Land Bank has largely failed to achieve its primary objective of adequately financing the agricultural sector, especially SMEs. For the year 2015/2016 the bank received credit applications totaling R2 billion but only R1billion was approved. That means 50% of applications were declined. Usually the small scale farmers receive loans for much less than what they requested. But theoretically it can be argued that due to adverse selection problems faced by banks, collateral offered by borrowers could alleviate this (Stieglitz and 2011). It is argued that low-risk borrowers are prepared to pledge better collateral as a sign of their capabilities to fulfill their debt obligations (Jiménez and Saurina 2012). However, banks do not accept this and as such tend to establish a positive relationship between the level of credit risk and the value of collateral.

Another crucial factor is the inability of SMEs to manage risk. The research findings show that this is a very significant factor. As already alluded to, poor quality of financial

statements from SMEs is another cause of poor credit extension by the Land Bank. But generally, SMEs are considered risky by banks.

5.2.4 CREDIT APPRAISAL TECHNIQUES USED TO MINIMISE CREDIT EXPOSURE AT LAND BANK

The research findings show that credit appraisal plays a paramount role in the decision-making process regarding the granting of credit. As noted earlier, it is difficult for banks, without a proper credit analysis, to effectively lend to SMEs. They experience problems of non-performing loans. It was noted that the Land Bank uses a combination of asset-based lending techniques, small business credit scoring lending and financial statement lending technique. But from the questionnaire it emerged that the financial statement technique is the most predominant at Land Bank. The main reason could be that, when using financial statements, one can categorically determine if the business is profitable or not, including their cash flow as well as net worth. These are important aspects in the credit appraisal process.

5.2.5 STRATEGIES THAT COULD BE USED TO HELP IMPROVE CREDIT APPRAISAL SYSTEM AT LAND BANK.

The respondents revealed that the bank uses the following strategies to help improve the appraisal systems currently in vogue at the Land Bank:

- Higher pricing and higher collateral. At Land Bank SMEs are required to pledge tangible or fixed properties as collateral. The bank considers collateral as an important aspect in the lending process as this provides security in the event of failure by the borrower to repay the loan. Research reveals that most SMEs survive only for the first three years after inception. This is the reason why banks prefer to provide credit finance to SMEs in the later stages of their life cycle. However, the need for high collateral by banks has been criticized for stifling economic development since SMEs cannot afford it.
- The bank has a statutory pledge in terms of any inventory that is bought through Land Bank funds. The bank takes a cession of the debtors plus any other additional asset security that a client can offer. The quality of the accounts receivables and

inventory is a very important aspect in the decision-making process because the accounts receivables are the amount of debtors that the business has, which is the cash that they are expecting in the near future. This enables the bank to determine whether the business will be able to adhere to the terms of the loan contract or not. Inventory is also very important as it is the amount of goods which could be sold for cash. 80% of the respondents agreed that accounts receivables and inventory are equally important in the decision-making process.

- The credit appraisal process conducted by the banks forms part of its risk assessment. It has been noted that the bank is very strict in its selection process in terms of choosing the right borrower and rejecting a bad one. This is the reason why almost 50% of credit applications are rejected at Land Bank.
- The bank has tried to keep its business model simple and efficient though it has also been criticized for the high interest rates charged to SMEs as they are considered risky. However, in some instances the bank provides subsidies for SMEs development which is a very good initiative. The model also entails post investment monitoring and mentorship.
- Good credit history of the applicant is essential for loan processing. Cash investments are used to secure monthly installments. Positive cash flow that is in line with the business finances comes in as a bonus for SMEs applying for credit lines. This will result in lower interest rate and the cost will therefore be low. The responses from respondents reveal that the history of the principal owner is important in the decision making to lend and set terms of the loan contract. The selection of the right borrower in terms of honesty and integrity is of primary importance. A proper investigation regarding previous dealings with the borrower, dealings with other players in the market and surrounding areas of the place of business is also very important. Also, information from suppliers is crucial in the decision-making process. Banks use information from suppliers in order to determine the business' repayment of credit patterns. The bank also uses that information to establish the relationship that the owner has with the supplier as well as how the credit facility is being serviced.

5.3 RECOMMENDATIONS AND CONCLUSION

5.3.1 CONCLUSION

Land Bank occupies a strategic position in the development of the South African agricultural sector. Development can only be achieved if the SMEs sector is adequately financed. The bank's mandate is to ensure that the sector receives the needed capital. The research findings revealed that the bank has struggled to meet the demand for credit finance by SMEs. The reason is not that the bank does not have the finance for onward lending to the SMEs, but its rigorous credit appraisal process acts as a major deterrent to the provision of finance.

A worrisome scenario is that most of these SMEs that fail to secure finance are startup businesses that could be the seedbed for economic growth since they constitute the majority of businesses in the country. The research findings, as corroborated by the literature review, show that almost half of loan applications by SMEs were rejected. Therefore, there is an urgent need for the bank to review its credit policy in order to strike a balance between greater access to credit and protection of depositors' money.

5.3.2 RECOMMENDATIONS

Access to finance by SMES is considered critical to the economic growth and development of South Africa. As revealed in this study, SMEs experience financial accessibility problems. This is exacerbated by stringent credit appraisal systems put in place by the banks. But banks argue that factors internal to SMEs are the major constraints to access to finance. Such constraints include lack of collateral, limited management and technical skills, lack of credible financial accounts and poor technology. In cases where SMEs get the finance, the interest rates charged are very prohibitive. It is therefore important for policy-makers to come up with regulatory frameworks that adequately cater for credit provision to SMEs. The regulations should seek to overcome all the impediments that hinder access to finance by SMEs. Such a framework should be supported by good information dissemination systems that allow for effective credit checks on the credit history of the borrowers.

The SMEs should not remain complacent and do nothing about it. They should rather improve their systems and adopt modern management techniques. This could enable

them to easily reach out to the formal sector and take advantage of the opportunities available. As noted in the study, most SMEs' records are in a shambles, rendering them unattractive to receive credit as proper records reflect a clear and realistic picture of the operations of a business. It is therefore critical for these small businesses to improve their accounting and financial records systems as it is not only beneficial to banks; but also crucial to the tax authorities and the proper management and monitoring of the business.

The network between SMEs and larger firms should be promoted. This improves SMEs operating efficiencies and capabilities and thus enhances their chances of accessing credit from banks. It is also important for SMEs to invest in skills development and infrastructure in order for them to benefit from e-finance. There is also need for capacity building in terms of improving on financial literacy and management skills.

Information asymmetry and opacity about SMEs should be reduced. In other words, there is need to ensure that all players in the financial sector have sufficient information about SMEs in order to make objective and relevant decisions regarding credit provisioning. The control of information should not be the preserve of dominant players in the financial industry as this stifles competition. Adequate information should be available to enable banks to accurately assess SME risk. This, in turn, would enhance their willingness to extend credit and other financial services to SMEs that are currently marginalised or shunned.

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