Credit Risk Evaluation of Swedish SMEs
- A Banking Sector Perspective

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ABSTRACT

As a result from the latest financial crisis, the banking industry has undergone major modifications during the last years in order to limit banks’ risks. A vast majority of existing literature tends to focus upon credit risk evaluation methods and techniques mainly concerning quantitative measures and large companies. Thus, the lack of research regarding credit risk evaluation of SMEs is profound, especially considering Sweden. With the dominant market share of SMEs compared to large corporations the authors found it interesting to further explore this area of the credit assessment process as SMEs largely impact the Swedish business sector.

The purpose of the thesis at hand is to explore and provide empirical evidence of which criteria banks assess when evaluating credit risk of SMEs in Sweden. In regards to the purpose the authors have chosen to adapt the perspective of the banking industry throughout the thesis. In order to bridge the research gap the following question was established, “How do banks evaluate credit risk of SMEs in Sweden?” In light of the lack of research regarding qualitative assessment of credit risk, the authors found it interesting in terms of developing new theoretical and practical knowledge to establish the following sub-question, “What are the qualitative criteria used by banks when evaluating credit risk of SMEs in Sweden?” Further, as existing literature mainly focus on large companies the authors found it interesting to compare the findings regarding credit risk evaluation on SMEs to the evaluation process of one of the largest credit rating agencies. As a result the second sub-question was established as following, “Are these criteria similar to the criteria used by Standard & Poor’s in their rating model?” These questions were conducted in order to provide the authors and the reader with further insight regarding the criteria used by banks in their evaluation process.

An inductive approach was adopted, in line with the epistemological stance of interpretivism and the ontological belief of constructivism. With this in mind, the authors of the thesis conducted a qualitative exploratory research employing narrative interviews in order to collect the data needed, as of the lack of existing research to address the research questions.

The results of the research were that the criteria used in the assessment of credit risk tend to alter from advisor to advisor. The most commonly used criteria by the advisors are budget, business plan, customer’s customers, internal and external discipline, financial statements, industry specifics, historical accounts, key individuals, relationship, repayment capacity and the owner/individual. It was discovered that the qualitative criterion of assessing the individual majorly impacts the credit risk evaluation. However, what matters in the end is the overall impression of both qualitative and quantitative measures of the firm.

In regards to sub-question one, the authors established a list of qualitative criteria used by advisors in their credit risk evaluation of SMEs, the most widely used criteria among the advisors are the owner/individual, key individuals, internal discipline, industry specifics, external discipline, customer’s customers, relationship and business plan. In comparison with the criteria used by Standard and Poor’s and the banks, it was evident that the criteria used in the evaluation differed a lot between the two.

Keywords: Credit Risk, Risk Evaluation, Banks, Financial Institutions, SME, Credit Ratings, Standard & Poor’s, Capital Structure, Finance, Bank Loans, Qualitative, Quantitative
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1. INTRODUCTION

In the introductory chapter the authors will start by addressing the problem background to give the reader a broader understanding of the research topic. Continuing the authors present the research gap, research question, purpose of the thesis and contributions. Lastly, limitations of the thesis project are presented before a short description of the disposition of the thesis is presented.

1.1 Background

An erudition of the recent financial crisis was that the financial sector was over-levered and not able to absorb the subsequent credit losses (Antao & Lacerda, 2011, p. 1380). As a result, the banking industry has during the last years undergone major changes in terms of stricter regulatory framework demands in order to limit the banks’ risks. Bruni et al. (2014, p. 766) concludes that the incentives of the sharpened requirement conducted by the Basel Committee on Banking Supervision (BCBS) was to maintain sustainability, create a healthier financial market and to develop new improved models to help financial institutions to evaluate financial risk.

BCBS (BIS, 2000) describes credit risk as “The potential that a bank borrower or counterparty will fail to meet its obligations in accordance with agreed terms”. Explained by Iscoe et al., (2012, p. 1604) credit risk is defined as the monetary loss arising as a result of changing condition in the perceived probability of default. Further, the authors state that a transition due to a reduction in probability of default of a firm resulting into a monetary gain is not very common compared to losses occurring because of credit downgrade or default. Consequently, monitoring credit risk and making correct decisions is important for avoiding unnecessary losses. Creal et al. (2014, p. 898) explain that after the latest financial crisis, accurately analysing credit risk by pinpointing common characteristics of firm default has become more important for financial institutions and regulators.

One of the major modifications when changing to the Basel II Accord was that banks became allowed to create their own internal methodologies in terms to evaluate the creditworthiness of their customers (Antao & Lacerda, 2011, p. 1390). Continuing, as many financial institutions have suffered from heavy losses due to a steady upsurge of default on loans, assessment of credit risk have become increasingly important (Zhou et al., 2010, p. 127). The authors further conclude the need for accurate models supporting the credit granting decision, since even a small misjudgement in risk evaluation of the customer may have major impact on future savings for the banks. This in contrast to the standardized approach, where financial institutions can trust external ratings, their own internal based ratings are customized established by advanced statistical models and historical collected data (Van Gestel et al., 2006, p. 1132). Also, Zhou et al. (2010, p. 127) emphasise that the most commonly used technique for internal methodologies is based upon quantitative models estimating probability of default of the applicant, based on historical data resulting in a credit score.

Banks play an important role in society and have a significant impact on the economy as they are the governing suppliers of external finance in a majority of economies. In Sweden there is no exception, where banks represent the primary source of financing for small firms (Bruns & Fletcher, 2008, p. 171; Sveriges Riksbank, 2011, p. 14). In 2013 firms active in the Swedish
business sector amounted 34% of the loans issued by Swedish banks, thus granting loans to companies are a central part of banks’ operations (Funered, 1994, p. 45; Bankföreningen, 2013). In the credit granting evaluation process, the bank mainly assess the repayment ability of the firm (Funered, 1994, p. 46). When evaluating credit risk, ratios are perhaps the most widely used method to assess a firm's financial status, often in relation to an industry average. It is also common to make historical analyses using key ratios, as they are easy to compare year by year in order to evaluate the development of the firm (Sigblad & Wilov, 2008, p. 181). Uchida (2011, p. 29) emphasise that the three main criteria that banks base their credit decisions on are the relationship between the bank and the borrower, the financial situation and collateral, and guarantees the company can offer the bank.

The three dominating credit rating agencies (CRA) on the global market are Standard & Poor’s (S&P), Moody’s and Fitch. The main objective of these companies is to provide guidance to investors with information and to regulate institutional investors in term of assessing credit ratings (Opp et al., 2013, p. 46). Credit ratings play an important role in the financial sector, as stated by Bottazzi et al., (2014, p. 113) credit ratings summarize a firm’s financial condition and are an attractive alternative to measure external resources. Continuing, the authors stress that banks heavily rely upon credit ratings, and explain that ratings represent a major part of the bank’s lending decisions. The authors also emphasise that investors commonly desire official ratings, however obtaining a rating is costly, the yearly cost amounts to 2 million SEK. This is a reason for why all firms are not available to attain a rating from a rating agency. Though, it is argued that the rating agency industry provides ratings of low quality, and that this is due to its monopolistic attributes, as Moody’s and S&P largely dominate the market (Xia, 2014, p. 450).

Even though smaller firms have a relatively insignificant impact on the overall economy alone, Small and Medium Sized Enterprises (SMEs) represent a majority of all active companies within European countries and there is no doubt that SMEs constitute an essential foundation for the European business sector and functions as a backbone of the whole economy (European Commission, 2015b). However, as there are only few SMEs that are publicly traded, there is a limited amount of information available regarding these companies making accurate valuations difficult. As a result, managers of SMEs will inevitably face challenges as to fund investments through outside capital.

Currently the interest rate in Sweden stands at a negative percent (Riksbanken, 2015). Large firms are less susceptible of monetary policy changes than SMEs’ and this is due to the lack of external funding sources as bonds or commercial paper of SMEs (Kobayashi, 2011, p. 1245). Continuing, SMEs access to financing alternatives are highly affected by monetary policy decisions, in light of this it can make it harder for SMEs to receive a bank loan, consequently it is important for SMEs to know what criteria that are evaluated when asking for a bank to enhance the chance to be granted credit. Observed by Israelsen (2013, p. 6) in his research is that the low interest rates do not favour companies to issue bonds, this is due to the fact that bonds returns are significantly impacted by fluctuations of the interest rate. This can be argued to be a reason of that bank loans is the primary source of external financing for SMEs at this point of time, also as issue bonds is not that common for SMEs.
1.2 Research Gap

Cited by Yurdakul (2014, p. 784) “The most important risk that banks are exposed to is credit risk, which involves loans that are not paid back”. After the 2007 financial crisis, scholars have come to put great emphasis upon empirical research as to understand the different underlying factors of causing the crisis. Hence, a vast amount of research has been devoted to the field of credit risk evaluation and credit risk management. However, a majority of these articles only or to most part consider quantitative variables and criteria when analysing credit risk. As a result, many of the models evaluating credit risk are statistical or numerical models leaving an unexplored gap concerning qualitative information regarding the company in the credit evaluation process (Chen et al., 2015, p. 127; Hainaut & Robert, 2014, p. 1). However, as pointed out by scholars, there is a significant lack of research incorporating qualitative factors within credit risk evaluation models. As a consequence the authors of the thesis at hand find it important to further explore this area of the credit assessment process.

However, a majority of loans issued by banks are granted to smaller firms, which the banks know relatively little about compared to larger publicly traded firms (Hanson et al., 2008, p. 584). Thus, as a significant amount of relevant information is needed as to conduct accurate credit risk evaluations, the lack of publicly available information of smaller firms causes certain restrictions to the risk assessment process of banks and other outside investors. As a result, the authors of the thesis find the limited information to be a problem for the SMEs that are seeking credit, as these firms might not have full knowledge about what aspects that they are evaluated on.

Even though the theories of capital structure have gained much attention within empirical research, the discussion has to a large extent come to focus upon the leverage ratios of larger firms as pointed out by among others Cassar & Holmes (2003, p. 123). As a result, the authors of the thesis find a significant gap in the literature as to explain the financing behaviour of SMEs which also affect the possibility of conducting research through the perspective of banks as the is little foundation to build the research upon. Emphasised by Yazdanfar & Öhman, (2015, p. 116) “It would also be useful to conduct qualitative studies, more specifically, interviews with SME owners and managers and with creditors such as bank lending officers, to investigate in greater depth how they view different investment alternatives”. Thus, the authors of the thesis is lead to believe that there is a clear gap within existing research in terms of qualitative studies on evaluation of credit risk regarding SMEs in Sweden.

Further, as empirical research have shown to almost exclusively cover data of listed corporations, a comparison between methods by banks used when evaluating SMEs and by S&P when evaluating large firms may provide new interesting empirical findings to the field.

1.3 Research Question

Since the financial crisis in 2007, banks have come to face stricter regulatory framework regarding capital adequacy and credit risk evaluation models. As a result, an increasing amount of empirical works has come to discuss the implications of these tighter restrictions. However, due to information limitations, most scholars have come to conduct research based on data from larger publicly traded corporations and even though SMEs constitute the majority of the banks’ customer base, little research has been done regarding these companies. Due to the different characteristics among small and large firms, applying the
findings of previous research on SMEs might lead to false conclusions. Hence, there is evidence that there is insufficient empirical research concerning credit risk evaluation of SMEs in Sweden which have led the authors to develop the following problem statement:

“How do banks evaluate credit risk of SMEs in Sweden?”

The authors thereafter chose to develop two-sub questions as to be able to provide meaningful empirical answers to the principal research problem stated above.

As detected in the research gap discussion, qualitative criteria within credit risk evaluation have shown to be a relative unexplored topic in existing empirical research, which leads the authors to develop the first sub-question in the aim of covering such matters.

a. “What are the qualitative criteria used by banks when evaluating credit risk of SMEs in Sweden?”

Continuing, as rating agencies are legally obligated to provide full transparency in contrast to the informational opaque internal evaluation processes of financial institutions, the authors develop the second sub-question as to detect possible similarities or differences.

b. “Are these criteria similar to the criteria used by Standard & Poor’s in their rating model?”

1.4 Research Purpose

The purpose of the thesis at hand is to explore which qualitative criteria Swedish banks use in their credit risk assessment of SMEs in the context of the credit granting decision as to be able to provide new empirical evidence to the area. The authors also aim to compare the findings made with the current credit risk evaluation process employed by S&P as to detect any similarities in criteria used when evaluating SMEs and large corporations. When speaking of granting credit throughout the thesis, the authors denote it as when SMEs approach the bank for the first time seeking a bank loan, this is before the bank has conducted its evaluation and negotiated the specifics regarding the loan such as timeframe, fees and interest rate.

Seen as it is the financial institutions that currently are holding the knowledge regarding the credit risk evaluation processes, the authors of the thesis find it necessary to throughout the thesis take the perspective of the banking sector. Thus, as to maintain such a perspective, the authors will gather data through interviews with corporate advisors five of the six largest Swedish banks offering credits to SMEs. The authors of the thesis perceive the purpose to be of high relevance as it is apparent that SMEs have more troubles to attract and generate capital than larger firms and as SMEs accounts for the main part of the Swedish market this is an important issue to further investigate.

1.5 Contributions

With the dominant market share of SMEs compared to large companies, the lack of research regarding credit evaluation of SMEs in Sweden is palpable, especially in light of qualitative variables. Thus the authors of this thesis consider their research topic to be of most relevance and can contribute both in theory and practice within this field. This is also the reason why the authors have chosen to adapt the perspective of the banking industry throughout the thesis.
Given the purpose of the thesis at hand the authors hope to make several contributions to a variety of stakeholders such as researchers, banks, entrepreneurs, firm owners and investors.

1.5.1 Theoretical Contributions

The authors of the thesis will explore a somewhat new area to empirical research and thus hope to provide new interesting empirical findings to bridge this research gap, which theoretically will contribute to the research area. Further, as the research primarily is focusing on qualitative criteria, which also is relatively unexplored, the authors hope that their findings will pave the way for future research. As the authors only will explore which criteria that is used it can be interesting to further develop the findings.

1.5.2 Practical Contributions

In line with the perspective taken of the banking sector, the authors of the thesis aim to provide financial institutions with practical contributions regarding the criteria used by Swedish banks in the credit risk evaluation of SMEs. Seen as banks commonly conduct internal ratings that are not available to outside stakeholder, it might be difficult to compare the processes and practices employed against other competitors. By fulfilling the purpose of the thesis, both the large participating financial institutions as well as smaller banks will be able to compare the criteria used against the findings that will be presented in this thesis. However, due to the lack of transparency in the credit rating process, taking on a banking perspective is also beneficial to SMEs as these firms might have trouble of knowing what they are evaluated based on. Stated by Bruns & Fletcher (2008, p. 171) the chance to be granted credit for a small businesses increase if the firm understand the bank’s evaluation process. Thus, by providing a list of criteria that Swedish banks commonly base their evaluation processes on, the authors of the thesis find this study to contribute valuable knowledge to the firms seeking external credit. Specifically, this will benefit SMEs and entrepreneurs with new start-up, as if they get a better grasp of what they are evaluated on they can put greater emphasis on these specific aspects and hopefully increase the chance of being granted credit. Continuing, this will also indirectly benefit banks as SMEs will be better prepared, hence saving time for banks as they do not need to have several meetings with the firms where the firms need to complement information required for the evaluation process.

The second sub research question is stated as to compare the findings made by the authors regarding the criteria used by banks when evaluating SMEs, to the criteria incorporated in the credit risk assessment made by S&P. As S&P’s ratings primarily are applied on large firms, it will be interesting to determine if there are any similarities amongst the evaluation criteria of S&P and Swedish banks. Due to that banks’ rating criteria is not public available in comparison with the rating criteria used by S&P, small firm investors such as business angels tend to have trouble evaluating these types of firms and consequently, the authors of the thesis wish that the outcome will supply investors with valuable information. If the criteria used by banks are equivalent to the criteria used by S&P, investors can apply the publicly available model from S&P that generally are used on large firms to their evaluation of small firms in their investment decision. This is also beneficial, since making a credit evaluation model is expensive which the common single investor most likely cannot afford. Indirectly this would correspondingly benefit SMEs because it might help firms to get a more fair judgment of firm value, as SMEs can be somewhat difficult to accurately price without the right instruments.
1.6 Limitations

The authors of the thesis at hand aim to explore a relatively new area to empirical research. Hence, as to provide valuable findings and fulfil the purpose of the study the authors find it necessary to state certain limitations. That is as to ensure quality of findings and guide the authors throughout the research process.

The thesis at hand will be conducted taking the perspective of the banks, hence ruling out the standpoint of regulators, borrowers and other stakeholders. However, exploring the view of the corporate customers upon the credit risk evaluation process of banks would be interesting. Further, in line with the stated research problem, the authors will only consider the credit risk evaluation of SMEs excluding a discussion regarding larger companies from the analysis. The number of banks participating in the study is limited to five of the six largest banks in Sweden due to due to the availability of the banks, as well as time and resources constraints of the authors of the thesis. As a result, ten semi-structured interviews will be conducted with corporate advisors in the north of Sweden which believed to function as a sufficient base in order to generalize the finding to the entire Swedish market.

Another limitation to the thesis is the decision to only evaluate Swedish SMEs that seeks credit. This is as market conditions, regulations and other country specific characteristics might differ and hence influence the credit risk evaluation procedures of banks. By excluding SMEs of other nationalities, the authors will be able to evaluate a homogenous group with similar conditions in terms of country specific means however, a geographical extension may contribute with interesting findings.

There are three main credit rating agencies, S&P, Moody’s and Fitch. In this thesis the authors have limited themselves to only examine one of the largest rating agencies due to the limited time frame. As the rating agencies should generally provide the same ratings, a random sample was conducted through which S&P ultimately was selected to be incorporated in the study. Since the authors are going to investigate if there are any similarities with the findings of criteria used by banks in the research, it would be to extensive work to compare with all of them however this is something that will be discussed in terms of future research in the end of the thesis.

1.7 Disposition

Introduction: The purpose of the introductory chapter is to provide the reader with a general understanding of the research topic and from where it has been developed. Following the presentation of the problem background, the authors of the thesis argue for a gap in existing literature. Further, the research question is stated, along with a discussion regarding the purpose, contributions and limitations of the thesis.

Research Methodology: To be able to conduct the thesis in an appropriate manner this chapter presents an outline of the methodological approaches that the research is based on. First, the authors present the chosen subject, preconceptions, and perspective, followed by the structure of the research, philosophies and the research method. The authors end the research methodology chapter by discussing ethical considerations and conduct an assessment of the literature and sources.
**Theoretical Framework:** Relevant concepts and theories in regards to the research topic will be presented as to provide the reader with further knowledge. The chapter starts by presenting credit risk, regulation, the lending process and evaluation criteria. Further, the authors more deeply cover ratings including rating agencies and variables used to determine ratings followed by an assessment of firm size. Then, main capital structure theories are evaluated. Lastly, the theoretical model used in the research is presented.

**Empirical Method:** This chapter presents the practical method, starting by determining different criteria and the methods for collecting data and the selection of participants. Further, the authors present their preparation and conduction of the interviews and how the authors are to code and analyse the empirical data. The chapter ends with a quality assessment of the thesis and a discussion regarding ethical considerations.

**Empirical Findings:** In this section the authors of the thesis first present the financial institutions and participants taking part of the study. Following, the empirical findings are disclosed in accordance to the codes developed in chapter four, Clientele, Criteria, The Process and Overall Assessment.

**Analysis:** The chapter contains an analysis of the empirical findings which are discussed in relation to the theories and models provided in the theoretical framework chapter. Thereafter, a section of the analysis regards the comparison with Standard & Poor’s and in the end of the chapter a short summary of the analysis is presented.

**Conclusion:** In light of the analysis of the findings, a conclusion is established and presented. Starting by providing a short summary of the methodological choices made, continuing by answering the authors’ research questions and minoring of the identified research gap. A discussion regarding the fulfilment of the purpose and contributions are presented followed by recommendations for further research. Lastly, societal considerations are brought up and end the chapter.
2. RESEARCH METHODOLOGY

The second chapter of this thesis starts with a short description of the choice of research topic and a presentation of the authors’ preconceptions. The main objective of this chapter is to provide the reader with an overview of the theoretical methodological standpoints. The authors will present the different standpoints ending with the research structure, ethical considerations and lastly an assessment of literature sources.

2.1 Choice of Subject and Preconceptions

When conducting research the previous experiences and background of the researcher can never entirely be excluded as personal values and beliefs inevitably affect our behaviour and actions (Bryman & Bell, 2011, p. 29). That is, individuals may perceive and interpret situations differently as a consequence of their past experiences and preconceptions and as a result their actions are likely to be affected by it. Bryman & Bell (2011, p. 30) suggest the values and preconceptions held by the researcher to permeate every stage of the research process, and hence stress the importance to take into consideration every possibility of bias.

The principal influence to the chosen topic of the thesis project stems from the authors’ educational backgrounds. Currently enrolled at the business administration program at Umeå School of Business and Economics, the authors of the thesis will major in financial management. Due to the wide range of courses taken, the authors have gained sufficient knowledge within related subjects such as accounting, entrepreneurial finance, organizational design and economics. Continuing, as the latest course studied was financial management D, the authors also have gained a deeper knowledge regarding investment opportunities, financial institutions, and risk management and evaluation techniques. The educational background has great implications on the preconceptions of the authors of the thesis. As to minimize the possibility that own conclusions will be drawn without empirical and academically ground, the authors will conduct a thorough systematic literature review as to critically evaluate previous research related to the chosen research topic. It is necessary to take into consideration the fact that the authors’ current knowledge of financial concepts and theories may affect the structure of the thesis and how the empirical findings are interpreted.

In addition to the academic courses previously completed, one of the authors has gained experience within banking as she is currently employed by one of the largest banks in Sweden. Through an internship at the bank, she experienced the functions and routines of all departments of the bank. It was under that time at the corporate department even greater interest in the subject of corporate advisory and lending evoked. Thus, it is not only knowledge from studying that has contributed to the authors’ chosen research topic but also practical experience has influenced the authors in the selection of thesis topic which is believed to be of benefit as it gives the authors another dimension as to how the chosen topic of research is approached. However, it is necessary to consider the fact that one of the authors is employed by one of the banks taking part of the study at hand as it may have certain implications to the preconceptions held by the authors. As mentioned by Bryman & Bell (2011, p. 30) developing a close relationship with participants may affect the researcher’s feelings and attitude towards interviewees and thus the data collected. Hence, great emphasis
will be put into maintaining an open and objective approach towards all participants of the thesis at hand as to minimize the risk of affecting the findings in some way.

The authors have always been interested in corporate finance and could hence see themselves working as corporate advisors or something within the same area in the near future. This has been one contributing factor to the choice of the research topic. In light of the facts presented in the problem background the authors want to investigate what variables are used by banks when granting credit and also see if there are similarities with the variables used by S&P. Also as the lack of qualitative variables has become more and more established in research the authors find it interesting to explore further. Taking all this into account, the authors hope that they will be able to contribute with new and interesting understandings by conducting research within the subject of criteria used by banks when evaluating credit risk especially in terms of the qualitative values.

2.2 Perspective

The thesis at hand approaches a topic that relates to the procedures employed by banks in the process of evaluating credit risk of SMEs. As a result, the authors of the study will explore a situation that regards an interaction between two separate parties, the banks and the companies seeking financing. Hence, it is important to clearly define the perspective taken by the authors of the thesis as to avoid any possible confusion.

Due to the relatively little empirical research available regarding criteria used by banks in the process of credit risk evaluation, the authors of the thesis believe that conducting the study in perspective of the banks will provide an initial foundation to further empirical research. In regards to the purpose of the thesis, the authors will hence take the perspective of the banking sector, as to be able to understand the underlying aspects of the stated research problem. As a result, the methodological standpoints, theoretical framework, collection of data and empirical analysis will be done in the viewpoint of the banking industry.

2.3 Research Philosophy

“The development of knowledge and the nature of that knowledge” is how Saunders et al. (2012, p. 127) explain what the research philosophy is. It is an important selection upon which research philosophy the researcher adopts, as these assumptions will influence the entire research, from the strategy to the methods used as a result of the chosen strategy (Saunders et al., 2012, p. 128). Johnson & Clark, (2006) state that the choice of philosophical standpoint will significantly impact the research, not only in terms of the understanding of what is being investigated but also what and how it is done. The authors will discuss two of the philosophical standpoints more in thorough in this thesis, namely epistemology and ontology.

2.3.1 Epistemology

Epistemology regards what is viewed as acceptable knowledge within research, the purpose is to determine what knowledge is, how it is conducted and possible limitations (Saunders et al., 2012, p. 134). Epistemology contributes to answer what scientific practices and which processes that constitutes to defining answers. Though there is no standardized way of answering these questions, rather it’s a mixture of different epistemological directions and commitments that forms the answer (Eriksson & Kovalainen, 2008, p. 14). In light of this
there are two different standpoints of epistemology, positivism and interpretivism. (Saunders et al., 2012, p. 134)

The philosophical stance of positivism represents the view of natural science, the researcher prefers data collected from an observable reality and looks for casual relationships and regularities in order to generate law-like generalities. Explained by Saunders et al. (2012, p. 134) is that a positivistic research approach is based on a value-free way as far as possible. Further the authors state that in order to conduct research in a positivistic manner the researcher uses existing theories to create hypotheses, these hypotheses are later tested and become either confirmed or rejected in order to further develop theory. Interpretivism is the opposite of positivism, it denotes that the social world is too complex to generalize and create laws in the same manner as in physical science. Continuing, the differences of humans in the role as social actors are important to comprehend. This is due to that you cannot overlook the way people play a part of the social world, as the social role influence their everyday life in accordance with people interpretations. A challenge for the researcher obeying the interpretivist philosophy is to embrace an empathic stance meaning, entering the social world of research trying to understand and see the world from the participants’ point of view (Saunders et al., 2012, p. 137).

In light of this, the authors will implement interpretivism as their formal epistemological stance in this thesis. As the main objective is to explore how banks evaluate credit risk, the positivism stance with creating hypotheses based on existing theories or numerical data and then either accept or reject the hypotheses is not suitable for this thesis. As an interpretivism stance focus on the social world, how people are influenced by their actions and trying to understand their point of view, the authors believe that interpretivism view of what forms acceptable knowledge is most applicable. As the authors will conduct interviews in terms of collecting data, and try to understand the respondent’s point of view and from that draw conclusions.

2.3.2 Ontology

Ontology is assumptions of the way the world operates and the specific views of researchers based on the nature of reality (Saunders et al., 2012, p. 130). Eriksson & Kovalainen (2008, p. 13) further describe ontology as ideas regarding the relationship between and existence of society, people and the world in general. There are two different approaches to ontology, objectivism and subjectivism/constructionism, both established by researchers to produce valid knowledge (Saunders et al., 2012, p. 131).

Objectivism assumes that people and their actions exist independently without affecting the social world with their perceptions (Eriksson & Kovalainen, 2008, p. 13). The purpose of a researcher is to in an objective manner to discover the nature of reality and assess how it truly works without bias from own preconceptions. Quantitative research is often assuming that the existents of the world is distinctive and separate, thus, an objective reality (Eriksson & Kovalainen, 2008, p. 13). The term constructionism is commonly used instead of subjectivism as reality is constructed by actions and previous experiences of people. Constructionism, assumes that the social world is produced by social interaction among people, meaning that through social interaction their understandings and views can change (Lee, 2012, p. 403). Much of the qualitative research is based on experiences and perceptions in a context, thus reality is a subjective viewpoint (Eriksson & Kovalainen, 2008, p. 13).
The ontological stance for this research will be from a constructionism point of view. The aim of this thesis is to gain deeper knowledge about which criteria that is used by banks when evaluating credit risk. As the assessment of credit is between two parts, the bank and the firm, they together construct a situation depending on people experiencing the situation. Thus, when conducting this research the most suitable for the authors is to apply a standpoint that takes this into account, as social actors perceive situations differently and therefore their actions are influenced by it, thus constructionism. Objectivism on the other hand, does not take people’s perceptions into account and often involves quantitative research the authors will not chose this approach.

2.4 Research Approach

Drawing conclusions from theories and empirical data in an understandable and credible way is one of the main challenges for scientists (Ketokivi & Mantere, 2010, p. 315). Saunders et al. (2012, p. 143) states that the relationship between theory and research may differ in the way it is being approached. Continuing, the authors describe that there are three main positions that a researcher can precede, the deductive approach, the inductive approach and the abductive approach.

The foundation of the deductive approach is to create hypotheses that are based on existing theory and later develop a research strategy for the optimal method to test these hypotheses (Saunders et al., 2012, p. 145). The approach is based on five interrelated stages, generally starting with establishing a hypothesis based on existing theory and a description of how the researcher intend to test this hypothesis. Continuing, the data is collected and the in turn the formerly stated hypothesis is analysed and either rejected or confirmed. Lastly, the researcher, depending on the results, may revise the theory initially used or confirm the theory. Acting in an independent manner is one important feature of the deductive approach, also the concepts used in a deductive approach needs to be able to be measure in a quantitative way (Saunders et al., 2012, pp. 145-146).

Through an inductive approach, the researcher might end up with the same theory as with a deductive approach, but the difference is that theory follows data. (Saunders et al., 2012, p. 146) Further, Bryman & Bell (2011, p. 13) states that the inductive approach is regularly associated with qualitative research. As stated earlier by Saunders et al., (2012, p. 145) deduction originates from natural science, whereas induction is based on social science. Further, the strength of the inductive approach is in the way the research can understand how humans interpret the social world, while the deductive approach only focus on the cause-effect relationship among variables, without understanding for the social aspects (Saunders et al., 2012, p. 146).

Abduction is the third research approach, which is a mixture of the earlier mentioned approaches. By undertaking an abductive approach the researcher can alter back and forth between findings and theory, and thus using both the inductive and deductive approach (Saunders et al., 2012, p. 147).

The aim of this thesis is to understand how banks evaluate credit risk of SMEs, this as to be able to explore the qualitative variables and measures that corporate advisors take into consideration when granting credit. As earlier discussed by the authors of the thesis, empirical literature tend to focus on quantitative measures and techniques within the evaluation of credit risk and there is little research established regarding quantitative aspects of risk evaluation,
especially in terms of SMEs. Hence, developing testable hypotheses through a deductive approach might seem suitable in the sense that there is a vast amount of research available within the specific area of credit risk evaluation. However, the rather substantial gap regarding qualitative variables within credit risk valuation of SMEs established by the authors of the study implies that it will be difficult to solely take on a deductive approach due to the lack of empirical research as to base hypotheses on. It would not be possible for the authors to take a deductive stance, to originate from existing literature and to test quantitative hypotheses and to be able to answer the research question.

Rather, in order to fulfil the purpose of the thesis and to be able to provide meaningful answers to the stated research questions, the authors of the thesis argue that it is necessary to first collect data. This due to the fact that the authors do not fully know what will be discovered and thus it would be dangerous as to limit the study to predetermined assumptions. The choice is further confirmed seen as Saunders et al. (2012, p. 146) state that an inductive approach is suitable when there is little existing literature and the focus is to generate data. Following an inductive approach will enable the authors of the thesis to explore the subject and through collection of data discover new interesting findings within the field. Though, it is important to have in mind that the distinction between induction and deduction are not as clear as theory portrays it in practice (Bryman & Bell, 2011, p. 14). Consequently, while the thesis at hand will be conducted taking an inductive approach, the authors believe it necessary to also incorporate certain influences of the deductive stance as to fulfil the overall purpose of the study at hand.

2.5 Research Design

The research design functions as a framework to the researcher as to how a theoretical research question will be related to practical empirical methods of collecting and analysing data (Ghauri & Grønhaug, 2010, p. 54). That is, in the sense that gaining and analysing information is the objective, the research design is the general approach to, or planning of the means to gain access to, gather and process information. The choice of research design will inevitably affect the way that research is conducted, and it is thus important that the research design does not only provide meaningful guidance to the researcher, but also that it reflects the researcher’s understanding for the research problem (Saunders et al., 2012, p. 160).

“Exploration in the extreme sense may mean that one starts from scratch, hardly even knowing what is interesting about the chosen phenomenon or subject area” (Mo, 1978, p. 165). When the topic of research is relatively unknown, an exploratory study may provide a useful framework as to develop understanding for the research problem (Saunders et al., 2012, p. 171). Through literature search, in-depth interviews or focus groups the researcher may explore the nature of the research problem as to gain new insights. Exploratory research tends to be well suited for unstructured research problems, as it allows for flexibility and change along the research process. Thus, the quality of information is also considerably affected by the respondents’ answers and the manner that interviews are conducted. Thus it is essential that the researcher possess the skills necessary to develop explanations through information gathering and observations (Ghauri & Grønhaug 2010, p. 56).

According to Saunders et al. (2012, p. 171) “The object of descriptive research is to gain an accurate profile of events, persons or situations.” The descriptive reach may be functioning as an extension to exploratory- or explanatory studies. A descriptive research design is appropriate in the case where the research question is structured and the researcher has a clear
understanding of the research topic (Ghauri & GrØnhaug 2010, p. 56). When the purpose of research is to look for and establish casual relationships among variables the researcher should follow an explanatory research design (Saunders et al., 2012, p. 172). The objective of an explanatory study is to investigate a research problem as to develop an explanation to the relationship among variables.

The objective of the study at hand is to provide new insights to a relatively unexplored area of factors used in credit risk evaluation among banks. The authors do not aim to provide an explanation between variables, but rather to explore the chosen topic by gathering qualitative data through semi-structured interviews. Consequently, as the aim of the study tends to move towards an exploration of the current methods and models used by banks when evaluating the credit risk of SMEs. The authors therefore find an exploratory research design appropriate, as it will enable for deeper understandings of how banks and SMEs interact in the process of granting credit, especially in terms of by what means qualitative values may be included in the decision process. However, though the overall objective of the study is of an exploratory nature, the second part of the research problem is stated such that it will provide a rather descriptive answer. As an extension to the overall exploratory research design, the authors believe that a descriptive design will function as a valuable compliment as to go about answering the research problem.

2.6 Research Strategy

Commonly a strategy may be defined as the plan of actions as to how one will achieve an objective (Saunders et al., 2012, p. 173). Within research the strategy therefore comes to regard the plan as how the researcher will achieve the goal of the research process, which is to provide an answer to the research problem at hand. There are numerous approaches as to how research may be conducted, and depending on the prevailing philosophical stance of the researcher, the research approach, and methodological choice, different methods of data collection and theory building will prove appropriate.

Table 2.1 Summary of Common Research Strategies

<table>
<thead>
<tr>
<th>Research Strategy</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>Experiment</td>
<td>Origins from natural science and is based on the study of probability of change in a dependent variable, caused by an independent variable. Rather than answering a research question, hypotheses are tested.</td>
</tr>
<tr>
<td>Survey</td>
<td>Quantitative data are collected through questionnaires or structured interviews and allows for descriptive statistical analysis.</td>
</tr>
<tr>
<td>Archival Research</td>
<td>Research based on data retrieved from administrative records and documents.</td>
</tr>
<tr>
<td>Case Study</td>
<td>The research topic is explored within the context of a specific situation or case.</td>
</tr>
<tr>
<td>Ethnography</td>
<td>The study of groups and cultures commonly through observations.</td>
</tr>
<tr>
<td>Action Research</td>
<td>An approach to research based on participation and collaboration with the aim of deriving solutions to real life problems.</td>
</tr>
<tr>
<td>Grounded Theory</td>
<td>Building theoretical clarifications of social interactions based on a simultaneous collection and analysis of data.</td>
</tr>
<tr>
<td>Narrative Inquiry</td>
<td>Research based on the belief that an individual may provide rich in-depth knowledge through story-telling.</td>
</tr>
</tbody>
</table>

Source: Saunders et al. (2012, pp. 173-190)
The aim of the thesis at hand is to explore a current phenomenon through a qualitative method of semi-structured interviews, which subsequently rules out the consideration of adapting a quantitative strategy such as an experiment or a survey (Saunders et al., 2012, p. 173). The authors are not to provide an explanation or a solution to a specific problem, but rather to explore the current means and methods employed by banks when evaluating credit risk among SMEs, hence an action research strategy is not employed (Saunders et al., 2012, p. 183). The authors do not aim to explore the individual perceptions, cultural aspect of banks, or specific settings among banks ruling out an ethnography and case study strategy. Further, as the authors have chosen to investigate an area of research that is relative unexplored, there are a limited amount of data available regarding credit risk evaluation of SMEs, the authors believe that an archival research strategy would prove difficult to adapt (Saunders et al., 2012, p. 179). Ruling out the above mentioned research strategies, the authors are led to the conclusion that a Narrative inquiry followed by a Grounded Theory strategy is most suitable to the thesis, which will be further evaluated below.

Saunders et al. (2012, pp. 187-188) propose a clear distinction between the common meaning of a “narrative” and how it may be used as a research strategy in qualitative research. A Narrative inquiry provides the researcher with a structure as to gather coherent data in the form of entire stories rather than the fragments of information gained through structured interviews or questionnaires. Since the aim of the thesis at hand is to explore a new area where little research has previously been conducted, the authors do not know what will be the outcome of the study. Hence, encouraging participants to account for their own experiences and beliefs as a complement to hard facts may provide the authors with interesting insights that were not thought of in beforehand. Continuing, the strategy of a narrative inquiry may be employed on smaller samples, as the researcher might be motivated to deeply explore the stories of a few individuals that are believed to bring much insight (Saunders et al., 2012, p. 188). In accordance with the purpose of the thesis at hand, the authors have chosen to interview employees with specific positions and knowledge within these banks. Hence, semi-structured interviews with a smaller sample of key individuals are believed to bring greater knowledge than surveying a vast amount of employees.

As mentioned by Saunders et al., (2012, pp. 189-190) the narrative research design is suitable for collecting a vast amount of qualitative data however it does not provide the researcher with an efficient structure of analytical procedures. However, due to the amount of data that are expected to be gathered, the authors of the study find the narrative inquiry to lack sufficient structures for analysis, and hence it is believe that a combination of two strategies may actually be of benefit to the study at hand.

Grounded Theory relates to the methodology of deriving theory inductively from data, and was developed as to explain social interactions and processes commonly within the field of business research (Saunders et al., 2012, p. 185). In common with the view of induction, theory is thought to be a result of empirical analysis of data however Grounded Theory may incorporate both inductive and deductive inquiries (Eriksson & Kovalainen, 2008, p. 163). Since the authors of the thesis do not know in beforehand what will be the outcome of the study an inductive approach and a qualitative data collection method is employed, indicating that Grounded Theory might prove a relevant method.

However, as pointed out by Suddaby (2006, p. 634) building theory from data do not imply that one may forget about existing theory nor leave it to the end of the research process. Hence, although existing empirical literature should not steer the research methods used, it
should provide deeper insight and knowledge to the researcher (Eriksson & Kovalainen, 2008, p. 163). As the authors aim to explore a new area through an inductive inquiry that is rather complex, they also feel the need to take guidance from current empirical theory throughout the research process as to be able to provide relevant empirical findings. Hence, the arguments of Suddaby (2006) regarding Grounded Theory do provide certain direction to the authors. Significant for Grounded Theory research is the process of coding data into categories such that the researcher will be able to analyse, compare and add new data if needed in order to build theory (Henwood & Pidgeon, 1992, p. 103). More specifically, Grounded Theory builds upon the concept of constant comparison, which involves the procedure of empirical analysis of data gathered as to detect possible similarities or differences in order to fully cover the complexities of the research topic being explored (Henwood & Pidgeon, 1992, pp. 103-104). As the authors aim to explore the criteria used by banks when evaluating credit risk, the process of coding and constant comparison is believed to be the preeminent method as it will enable the authors to structure a vast amount of information in order to gain new insight.

Described by Charmaz (2006, p. 130) “Constructivists study how- and sometimes why-participants construct meanings and actions in specific situations”. As to be able to take the individual perceptions of the participant into account, the researcher must come as close as possible to the specific situation, however it is necessary to remember that such an inquiry cannot fully be reconstructed as the exact experiences will vary among different participants. In contrast, the objectivist Grounded Theory approach belongs to the philosophical stance of positivism, advocating data to constitute objective information (Charmaz, 2006, p. 131). Hence, data is viewed as something already existing that is to be uncovered by an unbiased researcher. Charmaz (2006, p. 132) further argues that the objectivist Grounded Theory method implies a separation between the researcher and the participant, where individual interpretations are dismissed as influences.

As to be able to explore the criteria used by banks when evaluating credit risk among SMEs, the authors of the thesis find it important to consider the knowledge of corporate advisors at Swedish banks. As previously mentioned, the authors have come to adopt a constructivist philosophical stance of ontology, as the world is believed to be affected by our individual actions and interpretations. As a result, the authors of the thesis find it natural to follow the constructivist Grounded Theory method suggested by Charmaz (2006) rather than taking an objectivist approach.

2.7 Research Methods

When conducting research the collection of data is utmost important, there are two types of research methods for gathering the data, quantitative and qualitative. Saunders et al. (2012, p. 161) describe the distinction between quantitative and qualitative methods, suggesting that the quantitative method is numerical oriented and the qualitative method focus on words and the social aspects. Continuing, the collection of data in a quantitative method uses questionnaires, graphs or statistics that generates or uses numerical data. This compared to the qualitative method, which more commonly contains interviews or observations as the primary source of data collection (Saunders et al., 2012, p. 161).

Bryman & Bell (2011, pp. 410-411) further explain differences between the two methods, the researcher’s point of view is more reliant in quantitative research, while the participant’s viewpoint is in focus in qualitative research. Thus, the qualitative research tends to be more
subjective as the researcher develops a closer relationship with the participants, and it becomes natural that quantitative research adopts a more distant and objective point of view. Ghauri & Grønhagen (2010 p. 104) states that some researchers argue that quantitative methods are more scientific valid and thus better, but Saunders et al. argues against this statement and explains that the method used depends on the research question and what is aimed to be investigated. This is supported by Eisenhardt & Graebner (2007, p. 26) stating that the justification of which method to use is affected by the purpose of the research, if the aim is offer insight into social processes then a quantitative approach cannot be applied as quantitative data cannot reveal that.

The authors will conduct a limited number of semi-structured interviews and thus a qualitative approach will be adopted in order to collect the data needed. The aim of the research is as earlier mentioned to provide new insights about factors used in credit risk evaluation among banks, as it is relatively unexplored. Thus using a quantitative method with numerical hypotheses and a deductive approach based on existing theories would not be beneficial or possible in this case in terms of answering the research question. The study focuses on the perspective of the lenders and their viewpoint when granting credit, consequently a qualitative research approach is motivated, as the social world affects the participants understanding and perceptions. As stated by Eriksson & Kovalainen, (2008, p. 13) qualitative research is based on experiences and perceptions in a context, thus reality is a subjective viewpoint. As the authors wants to facilitate a deeper understanding of this issue, a qualitative method is suitable as it is associated with generating more detailed understanding than a quantitative approach.

2.8 The Chosen Structure of the Research

The authors have chosen to use a modified version of Saunders et al. (2012, p. 128) “research onion” in order to make the methodological chapter as comprehensive as possible. Seen in the model below the different approaches are presented, starting with the research philosophy whereas interpretivism and constructivism are chosen as the epistemology and ontology perspectives respectively. In the research approach, an inductive stance is selected, continuing by presenting an exploratory standpoint, a mixture of a narrative point of view and Grounded Theory and concludes with the pick of a qualitative research method.
2.9 Ethical Considerations

Ethics refers to the rules and regulations as well as the moral issues that come to form our actions and behaviour (Eriksson & Kovalainen, 2008, p. 62). In terms of social research, ethical and societal considerations play an important role as it relates to every action taken by the researcher throughout the research process. Continuing, Eriksson & Kovalainen (2008, p. 65) argues that research ethics concerns all steps from forming a relationship with participants to summarizing and presenting the results.

Saunders et al. (2012, p. 226) suggest “In the context of research, ethics refers to the standards of behaviour that guide your conduct in relation to the rights of those who become the subject of your work, or are affected by it.” That is, the researcher must not only take the direct participants of the study into concern, but also consider to possible effects that the study may have on society as a whole. Hence, not only will the authors of the thesis at hand put great emphasis upon mitigating possible ethical dilemmas that may occur, but they will also consider how the eventual findings of the thesis might come to affect participants, companies, institutions and the society as a whole.

Commonly, there are two main philosophical positions in terms of research ethics. As described by Saunders et al. (2012, p. 227) the deontological view is based upon the formation of rules, and the belief that such rules must be followed. Hence actions that are not in line with the rules are not considered as acceptable behaviour. In contrast, the teleological
view suggests that rather than what is stated by pre-set rules and regulations, the consequences of an action determine whether the behaviour was appropriate or not. Due to the nature of the thesis at hand, and the qualitative method of collection data applied, the authors find the deontological view to be the appropriate position to take. As the aim of the thesis is to study the criteria used by banks when evaluating credit risk through semi-structured interviews, the process incorporates the handling of sensitive information and personal data, which to some extent is also regulated through Swedish law. Hence following certain rules is of necessity to the authors of the thesis. Further, relying on ethical directions solely based on the outcome of an action is perceived as risky by the authors of the study. However, even though rules are followed there is still a possibility for negative consequences, which further leads the authors of the study to consider all parties that might be affected in some way.

Providing a solution to an ethical dilemma tends to be difficult due to the many conflicts of social norms and philosophical beliefs. As a result, there has been a development of approved codes of ethics suggesting ethical standards to be followed by researchers (Saunders et al., 2012, p. 228). In line with the deontological standpoint taken by the authors of the thesis, ethical guidelines for research stated by Umea School of Business and Economics will be applied throughout the research process. However, owing to the formality of such guidelines, it is important that the researcher is able to understand and interpret the codes of ethics not only in general terms, but in regards to the own research (Saunders et al., 2012, p. 229). The authors of the thesis at hand thus have taken into consideration the implications of choices made throughout the planning of how the study will be conducted.

Saunders et al. (2012, p. 237) suggest that the majority of the ethical issues that might arise during the research process may be foreseen and mitigated during the early stages planning the research process. Continuing, the process of seeking access to data is regarded to be one activity within research where great considerations to potential ethical issues are necessary. This leads the authors of the thesis to put great emphasis upon every choice made throughout the research process as to be able to handle ethical and societal matters that may arise. Ethical considerations quality issues in regards to the data collection process and the practical execution of the thesis at hand will be more deeply covered within chapter four.

2.10 Assessment of Literature and Sources

Bryman & Bell (2011, p. 91) suggest the literature review to confirm credibility of the research, as it shows upon the researchers understanding and ability to critically evaluating the literature and theoretical concepts. Also “Reviewing the literature critically will provide the foundation on which your research is built” (Saunders et al., 2012, p. 73). That is, the literature review will provide the researcher with a foundation from where the research problem is developed and concepts and theories are evaluated as to construct a theoretical framework. It is hence important that the critical evaluation of the literature leads to increased quality and relevance of theories introduced. Continuing, Saunders et al. (2012, p. 107) stress the importance of assessing the relevance of literature in regards to the problem statement and purpose of the research to be conducted. Due to the limited availability of literature regarding SMEs as well as qualitative criteria within credit risk evaluation, the authors have had to review a vast amount of academic literature as to retrieve relevant and valuable literature to be evaluated in relation to the study at hand.

Saunders et al. (2012, pp. 82-83) discuss different sources of information and suggest three main categories of sources literature and data. Primary literature generally refers to published
or unpublished information in its original form. In contrast, secondary literature is often found republished in books and journals as to increase the availability of the information. Tertiary literature however, relates to the means of locating primary and secondary literature, such as search engines, databases or dictionaries. The authors of the thesis at hand have gathered information through all three literature sources as to develop the different part of the thesis.

As to search for relevant books, mainly during the composition of the methodological chapters, the authors have used the online search engine of Umeå University Library. Further, predominantly paperback books have been used however at some instance also e-books have been assessed.

Saunders et al. (2012, p. 98) points out that information retrieved through general search engines such as Google may not always be of academic nature. That is, general search engines do not sort the results after academic relevance but rather after other criteria, such as your geographical location or previous searches. Continuing, publicly available search engines may lead you to information that is not externally evaluated (Bryman & Bell, 2011, p. 115). Hence, in order to ensure that the information is trustworthy and valuable, the authors of the thesis have searched for academic literature using the online database Business Source Premier (EBSCO) accessed via Umeå University Library. Further only peer reviewed articles has been accepted as reliable sources of information, and the literature searches has been conducted using relevant key words such as: Credit risk, SME, capital structure, risk evaluation, financial institutions, credit ratings, S&P, finance, qualitative.

Bryman & Bell (2011, p. 115) suggest that the reputation of the journal that an academic article is published in may tell something about the quality of the information it contains. As more articles are sent to the most respected journals, the competition may aid to increase the overall quality of the contents of these journals. Hence, as to ensure that the literature incorporated in the thesis at hand is of value, the authors have exclusively relied on academic articles published within acknowledged financial journals such as: The Journal of Finance, The Journal of Risk Finance, Journal of Banking and Finance and Journal of Business Finance & Accounting.
3. THEORETICAL FRAME OF REFERENCE

The purpose of this chapter is to provide the reader with an overview of the most important concepts and theories in regards to the thesis. The authors of the thesis will make an assessment of previous research and of its relevance to this study, in terms of providing a theoretical basis for the analysis. There are four main theoretical fields related to the thesis at hand, credit risk, credit ratings, firm size and capital structure. The chapter will start off by addressing credit risk and the determinants of credit risk, as it is significantly relevant and function as a foundation to the research topic. Continuing the concepts of credit ratings, firm size and capital structure are discussed in relation to the research problem, all of them provide context and deeper knowledge that later can be applied in order to answering the research question and the sub questions. A recurring subject throughout the theoretical chapter is firm size as its characteristics affect the different theoretical fields in various ways. Lastly, the research model is presented, showing how the different theoretical sections are linked together.

3.1 Credit Risk

The banking industry and the lending process represent a major part of the authors’ thesis work, and it is important to get an overview of the main parts influencing the financial industry in order to answer the research question. It is essential to understand the background of the industry more thoroughly and how it has evolved throughout the years. The authors of the thesis will start off by determining and evaluating credit risk, as it embodies the basis of the lending industry and thus is an important factor for the thesis. After the recent financial crises, more and more regulatory framework has emerged in order to control and keep track of the risks banks face, where the authors of the thesis will assess the development of this. As the main purpose is to evaluate bank’s lending process and what criteria they use the authors will deeply cover theories regarding the lending process and credit risk evaluation to able to draw conclusions of their findings.

The BCBS defines credit risk as “the potential that a bank borrower or counterparty will fail to meet its obligations in accordance with agreed terms” (BIS, 2000, p. 1). Continuing Iscoe et al. (2012, p. 1604) describe credit risk as the monetary loss arising as a result of changing condition in the perceived probability of default, further the authors claim that a transition resulting into a monetary gain due to a reduction in likelihood of default are generally small, compared to losses occurring because of default or credit downgrade. Thus monitoring credit risk and making accurate decisions is utmost important for avoiding unnecessary losses. Creal et al. (2014, p. 898) supports this as the authors state that after the financial crisis in 2008, analysis of credit risk has become more important for regulators and financial institutions as they attempt to pinpoint common features in firm defaults in to accurately assess risk.

3.1.1 General aspects

The Basel Committee determines that the most obvious and major source of credit risk to banks are loans however they also state that it is important for banks to consider the correlation between credit risk and other risks (BIS, 2000, p. 1). Understanding the correlation of credit losses is important due to several reasons, for example when managing portfolios, pricing structured credit products or setting capital requirement for financial institutions (Pu
The authors continue to discuss that the lack of understanding of credit risk’s correlation to other risks was one factor contributing to the financial crisis 2007-09. In light of this, as loans is such a major risk for banks it is important for us to understand how it affects the lending processes, and what factors that banks believe contribute more.

The financial sector represents a key player in many countries in terms of a funding source for firms with limited access to external and internal funds, and thus, heavily affects the economy and the firms (Chiu et al., 2015, p. 411). Though, credit risk is not the only risk affecting the financial industry, for mentioning a few there are market risk, liquidity risk and operational risk. Operational risk refers to “The risk of losses resulting from inadequate or failed internal processes, people and systems or from external events”, this definition incorporates legal risk, but eliminates strategic risk and reputational risk (BIS, 2001, p. 2). Continuing, Hull (2012, p. 469) describes liquidity risk as the risk that a security or an asset cannot be exchanged on the market rapidly enough to avoid a loss, thus the corporate cannot assess sufficient liquidity in terms of meeting its short-term obligations. Lastly, market risk is defined as the risk of changes in foreign exchanges rates, equity, interest rates and commodity prices (Vyas & Singh, 2011, p. 16). However, in this thesis the authors have decided to focus on credit risk, as it is the foremost risk influencing banks and their lending decisions and as it was a major contributing factor to the latest financial crisis. This is supported by Bruyere et al. (2006, p. 2) who emphasise that credit risk is the main risk facing banks due to the fact it cannot be eliminated through diversification and banks have to select and monitor the borrowers by themselves.

One major consequence of the last financial crisis was firm default, negatively influencing all stakeholders, from employees and suppliers, to debt-holders and shareholders (Bruni et al., 2014, p. 766). Continuing, the authors describe a second type of credit risk in light of SMEs, exogenous default risk, which aims to improve efficiency and cut costs in the supply chain in order to follow lean manufacturing principles. This can lead to that firms are exposed to higher risk as they are dependent on fewer suppliers, and in turn need to evaluate their risk exposure on supplier default risk. Thus, the authors state that credit risk is not only an issue for banks, investors and lenders to SMEs but also for all manufacturing firms granting credit also being vulnerable due to poor credit decisions.

Besides default risk, creditworthiness or counterparty risk is also closely related to credit risk. Creditworthiness risk is defined as the risk of the counterparty or the borrower to deteriorate their perceived creditworthiness without necessary defaulting resulting in a loss. In case of deteriorate financial institutions often compensate for this by demanding a higher premium (Bruyere et al., 2006, p. 8). Bruyere et al. (2006, p. 3) state that the fall of creditworthiness can be the starting point of default, which makes the two risks correlated so far.

3.1.2 Regulatory Framework

The Basel II Accord consists of three pillars, minimum recommendations for capital adequacy, monitoring processes and market discipline (BIS, 2004, p. 6). The first pillar concerns how the ratios are calculated, it includes rules on how banks should manage market, credit and operational risk (BIS, 2004, p 6). This was a central modification from Basel I as it did not take operational risks into consideration. The second pillar emphasises the dealing with banks’ risk management and the controls of the banks’ behaviour and to assess if their internal risk management processes are adequate in relation to their risk exposure (BIS, 2004, p. 158). The purpose of the third pillar is to give stakeholders’ access information about
banks’ risk management processes, risk exposures and capital adequacy ratio, hence increase the transparency of banks’ (BIS, 2004, p. 175).

Determining the treatment of credit and loans to SME depends foremost on two factors, the methods banks use to evaluate appropriate risk measures and the ability to apply the internal risk rating systems on different assets and different loans (Jacobson et al., 2005, p. 44). Continuing, the authors state that it is up to the bank itself to distinguish the riskiness of loans and counterparts, a feature of the new regulation is that SME loans will obtain a special treatment compared to corporate loans as less regulatory capital will be needed. This is due to that SME loans are to be considered to be less sensitive to systematic risk, “Their risk of default is thought to be largely of an idiosyncratic nature and, as a result, default probabilities are assumed to be more weakly correlated when compared with corporate loans” (Jacobson et al., 2005, p. 45).

The Basel Committee on Banking Supervision introduced the Basel III Capital Accords in 2009 with the purpose to replace the Basel II Capital Accords from 2004. Both the Basel II and III Accords presented unambiguous capital requirements regarding risk management and rules for controlling debt and liquidity risk in banks. The new regulations of capital requirements had led to stricter policies for granting credit, which has increased the competition within the industry (Bolt & Tieman, 2004).

Implied by Santos (2001, p. 53) there is a contradiction showed regarding that capital requirements will have a positive effect on banks. Several studies examines that risk-taking behaviour may increase due to capital requirements (Hoque et al., 2012, p. 457). Though, financial institutions are not the only ones affected by the Basel agreements, customers and borrowers suffer from indirect effects as the interest rate on different types of loans is influenced by the agreements (FI, 2005, p. 1). Such as if the financial institution needs to increase their capital buffer before a given time period, the strategy to obtain more money needs to be altered, one example of this may be to expand the spread amid the lending and borrowing rate.
3.1.3 Managing Credit Risk

Stated by Treacy & Carey, (2000, p. 168) one way of measuring credit risk is through credit ratings, but in response many large banks have initiated internal ratings for approving, analysing, pricing and monetisation of loans. Continuing, they explain that these internal ratings differ a lot from the ones from the large rating agencies as they are not revealed to outsiders and are conducted by bank personnel. Internal ratings provide important output, summarizing the risk of a loss due to a borrower’s inadequacy to meet its obligations. As these internal ratings not are publicly available, the firms cannot be sure on what there are evaluated by, consequently the research will try to assess these criteria. As Bruns & Fletcher (2008, p. 171) state, when seeking credit the chance of being granted credit for small businesses increase if they understand the banks evaluation process. Thus, this makes the research interesting, as if the authors are able provide criteria that the bank make their assessment by for granting credit to SMEs, minor firms might become more prepared when seeking credit and consequently can enhance their chance of being approved.

A way to test default risk in terms of credit risk is through stress testing and scenario analysis. Flood & Korenko (2015, p. 43) explain the lack of usage of these measures in regards to the latest crisis and determine that stress testing is an increasingly significant instrument for understanding risk exposures. Though, the authors stress the importance of which scenarios to consider, they should be severe but at the same time plausible. Stress testing makes calculations of an institution or a portfolio and reveals the response of that institution or portfolio if a loss may occur. Continuing Hu et al. (2014, p. 82) explain stress testing as measuring the banks’ vulnerabilities to risk factors as exchange rate risks. Although, stress testing has received criticism, Hu et al. (2014, p. 81) argue that stress testing mainly is based on historical data and that risk events with low probability of occurring often are ignored.

Dietsch & Petey (2002, p. 303) explain that the new Basel Capital Accord enables financial institutions to conduct their own internal rating based models in order to evaluate minimum capital requirements. However, they continue to discuss that little effort has been devoted to small bank loans to SMEs despite the rather high share of exposure to SMEs’ in the banks' loans portfolios, particularly in Europe. Probability of default (PD) and the loss-given default (LGD) are frequently discussed measures when evaluating credit risk. The possibility of default of a firm under a specific period of time is the PD, whereas LGD is the loss of capital if the firm defaults, the underlying risk factors are argued to affect both measures in the same way. When PD is high it is implied that the LGD also is expected to be high, thus the overall credit risk increases (Creal et al., 2014, p. 901).

3.1.4 Lending process

The process of granting credit is conducted in a similar fashion in all Swedish banks, beginning at the local office that handle small loans up to regional level that grants larger credits. When a company turns to the bank with a loan application the bank officer prepares a basis for the decisions that later are forwarded to a credit committee, depending on the amount, a credit application can go through several credit committees within the bank before a decision can be made. In some cases, the bank's board of directors might need to get involved in a decision on granting credit (Sveriges Riksbank, 2001, p. 66).

Bruns & Fletcher (2008, p. 171) state that banks are the primary source of financing for small businesses in Sweden. Further, the authors state that almost half of all firms younger than two
years old have commercial bank loans as their primary source of financing. Loans offered from the Swedish banks has under the past several years increased, in the end of 2013 loans amounted 3339 billion SEK, whereas 34 percent was represented by the Swedish business sector including large firms and SMEs (Bankföreningen, 2013). Thus, the authors of the thesis can conclude that the Swedish business sector accounts for a large part of the Swedish banks’ business and it is essential to understand financial institutions lending activities.

### 3.1.5 Evaluation Criteria

Walker (1989, p. 285) and Binks et al. (1992, p. 35) explain that SMEs often have problems achieving bank loans. Bruns & Fletcher (2008, p. 171) state that when small businesses seek loans the chance to be granted credit increase if they understand the banks evaluation process, which also increase the probability to obtain a better credit rating. A stronger credit rating enables the firm to receive a lower cost of credit and to finance the firm’s capital requirement (Bruns & Fletcher, 2008, p. 171). Correspondingly, a borrower is more likely to be granted a loan if it has an established relationship with the lender, for example as a source of financial services, though the length of the relationship stands irrelevant (Cole, 1998, p. 959). Argued by Cole this supports that financial institution can throughout their relationship receive valuable private information from the borrower that they would not had accessed otherwise.

The cost for banks to maintain relationships with the customers is often ignored, previous studies show that banks often lowers the charge of interest on loans if the bank has a history of transactions with the borrower (Dahiya et al., 2003, p. 375). If a borrower suffers of financial distress it should most likely harm the relationship between the borrower and the bank. Due to collateral and relationship banking, banks are able to minimize losses due to financial distress (Dahiya et al., 2003, p. 376). Thus, it indicates that maintaining long-term relationship with customers is in the interest of banks (Dahiya et al., 2003, p. 375). It enables bank to receive information of the borrowers financial status before the information goes public and act (Dahiya et al., 2003, p. 376). Hence, establish and maintaining a relationship with the lender seems to be an important criterion for SMEs in terms of assessment of credit.

Bruns (2004, p. 22) determine differences in earlier research regarding criteria that affect lending officers in their credit decisions. He concludes that several authors argue that the most important factors for receiving credit is the borrowers characteristics, whereas some state that the financial status of the borrower is the main projection of the credit assessment. Further, Bruns argues that other authors stress that lending is mainly based on security or collateral, and as long as the customer can allocate sufficient collateral, credit assessment should not be a problem. The most common collateral for corporates is a corporate mortgage which is a mortgage on a company's chattels such as machinery, inventories and accounts receivable. It gives the bank the right to receive dividends at the company bankrupt in the order specified by Priority Act (Lennander, 2006, pp. 15-16). Jankowicz & Hisrich (1987, p. 45) conclude that browning decisions rely on both quantitative and qualitative information, where the qualitative judgement is highly subjective. As stated, the findings of previous research are contradictory regarding criteria affecting lending decisions, this suggests that the author’s research topic will be of relevance and contribute some insight to previous research, as the authors will find out what criteria Swedish banks use in their evaluation.

It is concluded that previous accomplishments is something that banks evaluate risk of SME on, this means that assessing risk of a new company will be very difficult. Banks also have a propensity to waive or reduce the size of the loan unless they feel secure in the safety, which
it presents (Miller & Murphy Smith, 2002, p. 69). This together highlights importance for start-ups to present valid data, to the extent it exists, in order to be granted credit. The three most important factors when banks conduct its risk assessment is the company's past performance, financial position and expertise in the business project. All these factors connect with the company's past performance, which creates problems for start-ups where past performance is not there. Simultaneously, with the expertise in business from the owner/owners experiences and previous work which may increase the chance of receiving credit. Competence is also a indefinable factor and its importance for a future project is therefore difficult to predict, which in turn can create uncertainty among the bank whether credit should be granted or not (Bruns & Fletcher, 2008, pp. 184-185).

Financial institutions use various accounting variables in credit-scoring systems to evaluate potential borrowers in comparison with competitors within the same group norms or industry. The key accounting ratios are combined and weighted in order to create a credit risk score or a measure of probability of default. The credit risk score is than compared to a critical benchmark and a borrower is either approved or rejected a loan (Altman & Saunders, 1998, p. 1723). Hao et al. (2012, p. 1248) disuses the impact of differences in restrictions in the banking-commerce and conclude in not only affect the settings of the loan contract terms in form of lower cost of information production but also affects the relationship between the lender and the borrower.

Sommerville & Taffler (1995, p. 284) determine in their research that when bankers evaluate credit risk they tend to be overly pessimistic in their opinion. Banks differ widely in their use of different models assessing risk, among others, checklist systems are mention as one less quantitative evaluation technique in comparison with scoring systems which generates numerical ratings. However, the authors continue to mention that the use of scoring systems have declined in use over the recent years in favour of multivariate techniques, as correlation between bankers forecasts based on judgement and formal models exist. Therefore do banks as a complement rather than replacing the old models frequently use multivariate techniques as discriminant and legit analysis in their evaluation.

3.2 Credit Ratings

The authors of the thesis find it important to further look in to credit ratings, as credit ratings are one way of evaluating credit risk. The authors of the thesis want to look into the dynamics of credit ratings and how they are conducted in order to understand what the key drivers of ratings are. Further, the authors will look at the historically evolution of ratings and examine the accuracy of ratings by evaluated existing research within the field. This is highly relevant as one of the two underlying research questions is to assess if the criteria used by banks evaluating SMEs credit risk are similar to the criteria used by S&P in their rating model as their ratings mainly target large firms. In this part the authors will therefore try describe the credit rating process and the special determines of ratings with theoretical foundation.

3.2.1 General aspects

The main purposes of rating agencies are dual, first, is it to provide guidance to investors in terms of information and second to regulate institutional investors (Opp et al., 2013, p. 46). The rating agency industry is argued provide ratings of low quality, and it has been established that this is due to its monopolistic attributes, as the market is largely dominated by two agencies (Xia, 2014, p. 450). The author further state that entry of a third issuer-paid
agency negatively affected the industry and contributed to even more issuer-friendly and less informative ratings. There is a possible conflict of the rating agencies’ ratings, as they need to compromise in terms of pleasing their customers and provide qualitative ratings (Xia, 2014, p. 451; Opp et al., 2013, p. 47). Kotcha (2010, p. 67) states that criticism has been raised towards the rating agencies and the transparency of their rating criteria, especially considering the core models and their assumptions for conducting financial ratings. Hence, it hard for you as an investor to know to what extent you can trust the ratings provided by the agencies as the ratings has received massive criticism even though steps have been made to increase the quality of ratings. As stated by Duan & Leare (2012, p. 3239) the financial market needs transparent, reliable and independent valuation of credit risks. Since the entry of the Egan-Jones Rating Company (EJR), an investor-paid rating agency, the information quality has significantly improved for ratings from S&P.

The entities being rated by the credit rating agencies are usually major global corporations or national governments, primary bonds in the private sector respectively sovereign debt issued by the nation (Scalet & Kelly, 2012, p. 478). White (2010, p. 214) and Polito & Wicken (2014, p. 202) explain the shift from the investor pay model to the issuer pay model, as it is too expensive for single investors to pay for ratings or to make their own and the fee has now been transferred to the issuer. Further, Hirth (2014, p. 101) argue for the benefit of the issuer pay model, whereas the issuer want to signal quality and the investors incentive is to inspect quality, therefore he believe that the issuer should be the one paying for the rating. He continues to explain that this might cause a conflict of interest as credit rating agencies can profit from inflated ratings.

 Ratings play an important part in the banking sector, stated by Bottazzi et al., (2014, p. 113) credit ratings summarize a company’s financial condition and are an attractive substitute to measure external resources. Continuing, they emphasise that banks heavily rely upon the credit ratings, and explain that ratings represent at major part of the bank’s lending decisions. Gunnarsdottir & Lindh (2011, p. 30) continue the discussion by concluding that credit ratings are commonly used by banks in terms of assessing the credit quality of the firm to determine the price of a bond or a loan. The authors further explain that investors often desire official ratings, though obtaining a rating is costly, the yearly cost amounts 2 million SEK. This is one reason for why not all firms have the ability to attain a rating for one of a rating agency. But banks do have internal credit rating models for evaluating corporations’ seeking credit, banks might take other factors into consideration in comparison with the rating agencies criteria, for example, the size of the firm and historical relationship with the bank, meaning that the ratings from the internal process can differ from the agencies ratings (Gunnarsdottir & Lindh 2011, p. 30). As SMEs commonly not are rated, this makes the one of the underlying research questions interesting, as it aim to assess if there are any similarities between the criteria Swedish banks use for evaluating credit risk on SMEs and the criteria used by S&P. Hence, determine if S&P’s rating models can be transferred to SMEs’ in Sweden and not only large global companies. Ratings are not that common, especially considering SMEs, therefore it is motivated to further compare the criteria used by S&P and banks in Sweden.

S&P and Moody’s stand for approximately 40% respectively 35% each in terms of market shares, whereas Fitch holds a market share of 16% (ESMA, 2014). Thus S&P and Moody’s are the two giants of credit ratings and has a competitive advantage compared to Fitch. The authors of the thesis will only focus on one of largest agencies, as it is not plausible due to time constrict to investigate all three of the rating agencies and the criteria they use when conducting ratings. As the rating agencies should generally provide the same rating, the
authors of the thesis drew a random sample where S&P ultimately was selected for the comparison with the Swedish banks and the criteria banks use for evaluating credit risk of SMEs.

3.2.2 Standard & Poor’s Credit Rating System

S&P (2009, p. 1) explain that credit ratings are judgments regarding relative credit risk. Further, it is stated “Standard & Poor’s ratings express the agency’s opinion about the ability and willingness of an issuer, such as a corporation or state or city government, to meet its financial obligations in full and on time” (S&P, 2009, p. 3). Continuing, S&P emphasises that the credit ratings are not investment recommendations to sell, hold or buy, only a complementing factor for investor to consider when conducting their investment decisions (S&P, 2009, p. 1).

As seen in table 3.1, S&P uses a rating scale expressed. The ranking is later divided into two subcategories, investment grade and speculative grade. Investment grade refers to bonds or other debt securities that are viewed as having high credit quality and creditworthiness, historically it was defined as investments suitable for financial institutions (S&P, 2014, p. 10). Further, speculative grade emphasise ratings where the issuer face noteworthy uncertainties but currently have the ability to repay, in other words, these circumstances could affect credit risk. To be considered to be investment grade the rating must be BBB- or above, and thus ratings lower than BBB- is to be considered as speculative grade or non-investment-grade.

Table 3.1 Standard & Poor’s Credit Ratings

<table>
<thead>
<tr>
<th>Credit Rating</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>AAA</td>
<td>Extremely strong capacity to meet financial commitments. Highest rating</td>
</tr>
<tr>
<td>AA</td>
<td>Very strong capacity to meet financial commitments.</td>
</tr>
<tr>
<td>A</td>
<td>Strong capacity to meet financial commitments, but somewhat susceptible to adverse economic conditions and changes in circumstances.</td>
</tr>
<tr>
<td>BBB</td>
<td>Adequate capacity to meet financial commitments, but more subject to adverse economic conditions.</td>
</tr>
<tr>
<td>BBB-</td>
<td>Investment Grade</td>
</tr>
<tr>
<td>BB+</td>
<td>Speculative Grade</td>
</tr>
<tr>
<td>BB</td>
<td>Less vulnerable in the near-term but faces major on-going uncertainties to adverse business, financial and economic conditions.</td>
</tr>
<tr>
<td>B</td>
<td>More vulnerable to adverse business, financial and economic conditions but currently has the capacity to meet financial commitments.</td>
</tr>
<tr>
<td>CCC</td>
<td>Currently vulnerable and dependent on favourable business, financial and economic conditions to meet financial commitments.</td>
</tr>
<tr>
<td>CC</td>
<td>Currently highly vulnerable.</td>
</tr>
<tr>
<td>C</td>
<td>A bankruptcy petition has been filed or similar action taken, but payments of financial commitments are continued.</td>
</tr>
<tr>
<td>D</td>
<td>Payments default on financial commitments.</td>
</tr>
</tbody>
</table>

Source: S&P (2009, p. 10) “Ratings from ‘AA’ to ‘CCC’ may be modified by the addition of a plus (+) or minus (-) sign to show relative standing within the major rating categories”.

27
When conducting a rating for a corporate, S&P commonly use information provided from the issuer, the process often begins with assessment of the issuer’s creditworthiness before evaluating the credit quality (S&P, 2009, p. 12). Among others S&P evaluate, the legal structure for debt issues, the relative seniority and other debt issues and the priority of repayment in case of default and lastly the external support including for example, guarantees, letters of credit, collateral and insurance. S&P also evaluate both historical and current available information, also taking in to consideration foreseeable future events that potentially can impact the company (S&P, 2009, p. 4). Continuing, when for example rating corporate debt, S&P takes the anticipated fluctuations into consideration in the business cycle that might affect the evaluated firm’s creditworthiness. S&P states that it is important to stress that credit ratings are not a guarantee that an investment will not default or pay out, it is a mentioned before as a compliment to investors investment decision.

When S&P (2009, p. 7) form their ratings, they predominantly adopt mathematical models or analysts, or in some case a combination by the two of them. First, the model driven ratings are ratings exclusively focus on quantitative data, incorporated into numerical models, this approach can be used to evaluate creditworthiness of financial institutions in terms of funding, asset quality and profitability mainly based on the public financial statements from the institution. Secondly, the analyst driven rating is mainly conducted when the agency rate a municipality or a corporation (S&P, 2009, p. 8). An analyst in combination with a specialist team is assessed to evaluate the creditworthiness of the entity, often the information needed is obtained from public published reports, but also contained from discussion and interviews with the issuer. Continuing, the information is used to determine the entity’s risk management strategies, financial condition, policies, and operating performance.

Figure 3.2 Corporate Ratings
Source: S&P (2009, p. 12)

All information regarding the evaluation process of S&P’s assessment of credit rating are available for anyone, thus S&P has adopted the requirement of transparency towards all stakeholder. As seen in figure 3.2 above, the criteria used by S&P in their assessment of credit risk are presented. There are two main categories, business risk and financial risk, business risk regards not only to industry characteristics, company position but also specific country risk (S&P, 2013). Continuing, financial risk incorporates a cash flow and/or leverage analysis to assess a firm's financial risk profile, accounting and assessment of the capital structure of
the firm. In the analysis the business risk are more profoundly for investment grade and vice versa for speculative grade, thus the financial risk profile carries more weight. After combining these two categories you get a rating, but before the rating is final, additional factors that might affect the rating are evaluated. Presented by S&P these aspects are capital structure, diversification/portfolio effect, liquidity, management and governance and financial policy, every factor can both raise and lower the rating, how much is individually determined by descriptions and assessments for each factor.

The factors analysed within the business risk category profile usually is a mixture of quantitative information and qualitative assessments. The quantitative information embraces historical cyclicality of profits and revenues regarding assessing industry risk and the stability of the market, it may also include level of profitability and volatility in terms of deliberate a firm’s competitive position (S&P, 2013). Whereas the qualitative assessment includes for example, evaluating a firm’s competitive advantages and country specific risk as law risk, financial system risk, economic risk and institutional and governance effectiveness risk. S&P analyse the company’s strengths and weaknesses on the market and it is vigorous to its credit evaluation, it reflects the firm’s capacity to generate cash flows to pay its obligations in time.

When determining the financial risk profile, the evaluation focuses on quantitative variables (S&P, 2013). S&P assess patterns of historical, current and future cash flows, relative the firm’s cash obligations which they states as a good indicator of a firm’s financial risk. The agency uses a variation of credit ratios, mainly cash flow based to gain a thorough outlook of credit risk. However, S&P also take into account ratios that are most suitable for measuring individual characteristics and the business cycle in their evaluation. The predominantly factor is the repayment capacity of a company and the cushion the firm possess, measuring the firm’s ability to survive through stressed periods, commonly used to measure this is interest coverage ratios.

3.3 Firm size

Discussing different implications of firm size is of essence to the thesis at hand as to provide a comprehensive base upon which further knowledge may be generated. Hence, defining the characteristics of small and large firms will be necessary to the authors as to further gain insight as to how such factors may influence the decision-making, financing behaviour and operations of the firm. Seeing that the aim of the thesis at hand is to explore the credit risk evaluation of small to medium sized firms in Sweden, the authors believe it important to start off with a definition as to explain the specific characteristics of these firms in terms of size. However as the concept of firm size will be discussed throughout the thesis in regards to the different topics introduced in the theoretical framework, the authors of the study will only briefly present and evaluate the main attributes of size within this section.

3.3.1 General Aspects

According to the European Commission (2015a) the definition and classification of firm size is based upon the number of employees and either turnover or the recorded balance sheet total for the single firm as presented in Table 3.2. Generally, firms with fewer than 250 employees, and either a turnover less than € 50 million or recorded balance sheet total of mess than € 43 million is grouped into the common notion of Micro, Small and Medium Sized Enterprises (SMEs). Continuing, even though the number of European-based SMEs declined as a consequence of the 2007-2009 financial crisis, there has been a slow but steady recovery as
today SMEs stand for 99% of all European companies (European Commission, 2015b). Hence, discussing firm size in terms of SMEs is of relevance to the thesis at hand, as to generate further knowledge of the foundation of the business sector.

Table 3.2 Determinants of SMEs

<table>
<thead>
<tr>
<th>Firm Size</th>
<th>Employees</th>
<th>Turnover or</th>
<th>Balance Sheet Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Medium</td>
<td>&lt; 250</td>
<td>≥ € 50 million</td>
<td>≥ € 43 million</td>
</tr>
<tr>
<td>Small</td>
<td>&lt; 50</td>
<td>≥ € 10 million</td>
<td>≥ € 10 million</td>
</tr>
<tr>
<td>Micro</td>
<td>&lt; 10</td>
<td>≥ € 2 million</td>
<td>≥ € 2 million</td>
</tr>
</tbody>
</table>

Source: The European Commission (2015a)

3.3.2 Financing and Firm Size

In their study, Cenni et al. (2015, p. 250) discuss the implications of firm size on the type of relationship formed with financial institutions and supply of credit stating, “Since SMEs are typically limited to bank loans in their external means of financing, factors influencing the bank’s credit allocation decision have a stronger economic consequence for these borrowers”. That is, as smaller firms may be provided less financing options, the importance of existing lending relationships may become more evident than for larger companies. Continuing, Cenni et al. (2015, p. 260) found both large firms and SMEs to benefit from forming relationships with a limited amount of credit-granters suggesting forming few strong relationships may decrease the possibility of facing credit rationing.

Berger & Udell (1998, p. 614) suggest that in terms of small firms the need for financing will alter through the different stages of growth. That is, as the firm enter different life-cycle stages, the need for investments alter and hence, the demand for internal and external sources of funding. Berger & Udell (1998, p. 622) show how the possibilities for financing alter as the firm is growing, indicating that smaller and younger firms is more reliant on internal sources of capital due to the lack of collateral and historical records. However, as many SMEs are not listed on a stock market, the lack of publicly available data brings restrictions on research as well as on managers’ ability of gaining capital. Berger & Udell (1998, p. 626) argue that as small firms tend to to a larger extent be financed through personal funds of the owner, the lack of personal financial data causes restrictions upon researchers.

However, firm size also come to be of importance considering the macroeconomic environment of the business, and how economic shocks and changes come to impact the firm and the availability of external funding Berger & Udell (1998, p. 651). Small and less transparent firms may face problems as to build new relationships with banks in times of overall financial instability (Berger & Udell, 1998, p. 653). Continuing, other external factors such as a tightened monetary policy may cause financial institutions to decrease their outstanding credit, which in turn affects loan supply (Berger & Udell, 1998, p. 654). As a result, smaller firms will in such a case face greater consequences as they tend to be more reliant on bank credit than larger firms. Thus, the current financial situation in Sweden where the Central Bank has introduced a negative repo-rate should also have certain effects on firms as loans tend to be less costly. Hence, the findings of Berger & Udell (1998) are highly relevant to the thesis as to understand the financing possibilities and behaviour or SMEs.

Beck et al. (2005, p. 137) further discuss growth opportunities in a setting of financial, legal and corruption constrictions to the economic environment of the firm. However, notably Beck
et al. (2005, p. 140) employ a different size categorization than the European Commission suggesting SMEs to constitute firms with maximum 500 employees possibly due to the global sample. Hence, this differentiation must be considered as to evaluate the finding of the paper due to the fact that it results in a larger proportion of firms within the sample that are sorted under the category of SMEs than would with the European Commission definition. Nonetheless, Beck et al. (2005, p. 157) provide important knowledge to the field as the authors found smaller firms to be significantly more affected by financial obstacles than larger firms. Continuing, SMEs tend to be more restricted by collateral requirements, levels of loan supply and bank bureaucracy than larger firms are (Beck et al., 2005, p. 161).

Hence, smaller firms are substantially more sensitive to financial constraints throughout the growth process. The authors also found larger firms to be relatively unaffected by legal restrictions whereas growth rates of small and medium-sized firms within the sample were highly influenced. Lastly, different forms of corruption only showed a significant impact on small firms, indicating that the growth opportunities of these companies were negatively affected by the presence of corruption (Beck et al., 2005, p. 162). That is, as pointed out by the authors, firms operating in countries with stable financial and legal systems have greater opportunities to grow. Hence, in terms of the thesis at hand the result suggest that it is important to consider the economic, legal and political environment of the firm as to understand how SMEs in Sweden gain external financing.

3.4 Capital Structure

In order to finance investments and to generate future profitable cash flows, the firm must decide upon the sources of funding. Brealey et al. (2011, p. 369) argue that a significant amount of the cash needed as to fund new investments is generated internally, that is in terms of retained earnings or internal equity. However, as the firm is growing, internally generated funds may become insufficient as to fund new investment plans (Brealey et al., 2011, p. 370). As a result, the firm must then either increase retained earnings or turn to outside sources of funding. Continuing, other factors such as managers’ incentives cost of outside debt or barriers to financial markets may affect the firms’ willingness and ability to turn to outside sources of funding (Brealey et al., 2011, pp. 370-372). Hence, the capital structure of the firm essentially refers to the mix of equity and debt financing, and has come to gain vast attention by scholars.

Introducing the theory of capital structure is thus of essence to the thesis at hand, as it will contribute to the understanding of the behaviour of SMEs, and the needs and demand for external sources of funding. Consequently, the capital structure also provides valuable information to banks and credit rating agencies when evaluating the riskiness of the firm. The authors start by introducing three relevant capital structure theories, and thereafter additional factors that might affect financial managers’ choice of capital funding will be discussed.

3.4.1 The Optimal Capital Structure

Advocating a theory of capital structure irrelevance, Modigliani & Miller (1958, p. 268) argued in their first proposition that in market equilibrium, under the assumption of no taxes, the value of the firm must be independent of the choice of capital structure. Further, Modigliani & Miller (1958, p. 271) formulated a second proposition under the same market assumptions, stating that the expected return on the stock of a firm will increase with the debt-equity ratio. The two basic propositions of capital structure irrelevance have however come to
be questioned, as in reality there is no market fulfilling all stated assumptions. In their correction paper, Modigliani & Miller (1963) provided a modified extension of the theory allowing for taxation on corporate earnings. As interest payments are tax deductible, MM showed that there was a tax benefit of debt financing to the firm. That is, the value of the firm increases with the debt to equity ratio, assuming all else equal as in the case without taxes.

Following the original discussion presented by MM, Myers (1984, p. 575) identified the need for further understanding of the financial behaviour of the firm, arguing that the existing theories at that time did not manage to explain the actual financing behaviour of firms. As an additional layer to the tax benefit of debt, Myers (1984, p. 580) defined costs of financial distress as “the legal and administrative costs of bankruptcy, as well as the subtler agency, moral hazard, monitoring and contracting costs, which can erode firm value even if formal default is avoided”. Continuing, Myers (1984, p. 577) suggested that there was a trade-off between the issuing of external debt and equity stating that “A firm's optimal debt ratio is usually viewed as determined by a trade-off of the costs and benefits of borrowing, holding the firm's assets and investment plans constant”. That is, by choosing an optimal level of debt and equity the firm can maximize its value by balancing the costs and benefits of external financing as illustrated in figure 3.3 below.

![Figure 3.3 The static trade-off theory of capital structure](image)

*Source: Myers (1984, p. 577)*

Thus, as described by Brealey et al., (2011, p. 486) the trade-off theory of capital structure implies that the optimal leverage ratio depends on the maximal tax benefit that the firm may receive. That is, a firm with a significant amount of taxable income and tangible assets tends to benefit from a higher debt ratio. Hence, the trade-off theory may aid to explain variations in leverage ratios among industries, especially in terms of comparing firms with tangible and intangible assets. However, Brealey et al. (2011, p. 486) also point out that even though the trade-off hypothesis functions well in theory, it does not necessarily imply that all firms actually behave in accordance.
3.4.2 Agency Theory

The agency relationship is fundamentally a contract where a principal or principals appoint an agent to carry out certain tasks on behalf of the principal, and where the agent is assigned some decision making power (Jensen & Meckling, 1976, p. 308). The lower the share owned by the manager is, the less incentives does he have to act in the interest of other shareholders as e.g. dividend payments will reduce retained earnings that the manager otherwise could invest. Continuing, Jensen & Meckling (1976, p. 308) suggest agency costs to be the cumulative sum of costs arising from expensive monitoring, the bonding expenses of the agent and residual losses. The authors argued that agency costs are not merely the costs of monitoring activities, but also the expenses of motivating the agent that is, the cost of bonding, to act in the interest of the principal. The principal will thus be faced with a trade-off, where he must weight s costs of agency mitigation against the residual losses of the firm in the case when the agent is acting against the incentives of the principle.

The agency conflict as described by Damodaran (2011, p. 367) may also arise due to the diverse incentives and risk appetite of shareholders and bondholders. That is, as shareholders aim to increase the value of their shares, hence the market value of the firm, they will encourage actions that increase value. However, such actions often conflict the interest of bondholders whom tend to prefer stability as to secure their debt claims. John & John (1993, p. 905) continue discussing the importance of considering the relationship among shareholders and external claimholders. Even though compensation plans or control systems may be design such that agency costs of equity are mitigated, the shifting incentives of managers suggest that more risky debt may be taken on (John & John, 1993, p. 951). That is, minimizing agency costs of equity may lead to increased agency costs of debt. As a result, the authors suggest manager compensation plan so incorporate incentives as to consider agency costs of both equity and debt (John & John, 1993, p. 969). Hence, the agency theory, taking agency costs of debt into consideration, may prove useful as to explore the capital structure choices of SMEs that tend to have little or no external equity issued.

Further, the investment decisions made by the manager of the firm will be highly influenced by his own personal incentives, and not necessarily made solely in accordance to basic net present value evaluations (Eisdorfer et al., 2013, p. 550). That is, the authors suggested a difference between the leverage ratio optimal to the firm and the leverage ratio optimal to the manager in sense of compensation. As a result, by setting managers compensation leverage ratio equal to the target leverage ratio of the firm, managers may be more willing to work towards maintaining a sufficient leverage ratio as to optimize firm value rather than personal utility (Eisdorfer et al., 2013, p. 561).

3.4.3 The Pecking Order Theory

In contrast to empirical research advocating an optimal capital structure for the firm, the Pecking Order Theory suggests that managers have a hierarchical preference order of financing. According to Myers & Majluf (1984, p. 209) under the assumption of no financial distress costs, the firm will always prefer internal sources of financing, and if external financing is needed, it will issues the safest type of securities first, whereas common equity is rather seen as a last option.

Further, Myers (1984, p. 581) explains that the firm will set its target dividend pay-out ratio such that financial slack will be generated as to cover for future investment opportunities and
fluctuations in profitability. As dividend pay-outs are relatively static, the retained earnings of the firm will vary with the level of income. When excess cash is generated, the firm will engage in investment opportunities or pay off debt, whereas when profitability is low, the firm might sell off liquid securities. Myers (1984, p. 581) argued that the firm does not strive towards a target capital structure mix of debt and equity as there are two separate kinds of equity; internal and external, at the top and bottom of the pecking order hierarchy. Instead, according to the Pecking Order Theory, a firm’s debt ratio reflects the total amount of external financing demanded by the firm rather than a target optimal debt level.

![Figure 3.4 A Simplified Model of the Pecking Order Theory](Source: Myers (1984, p. 581))

Not all firms have access to capital markets, and in that case external financing through bank loans becomes a more prominent option. Further, the capital structure of small family owned firms are also influenced by the wish of maintaining control within the family, and thus family firms have showed to have higher debt ratios than non-family firms (Burgstaller & Wagner 2015, p. 93). Based on a sample of Austrian SMEs, the authors suggest that the pecking order theory explains financing decisions of Austrian family firms, however, they also point out the influence of other factors such as ownership structure and high costs of adjustments in capital structure. Hence, in relation to the thesis at hand, the empirical findings regarding family owned firms may aid the authors of the thesis at hand understand the incentives of seeking external financing among Swedish SMEs.

Harris & Raviv (1991, p. 306) suggest that the capital structure of the firm may be seen as a signal to outside investors of possible inside information held by the managers of the firm. That is because the performance of the firm has little effect on the value of debt, as in contrast to the value of equity. Hence, Harris & Raviv (1991, p. 350) argue that in the presence of asymmetric information, pricing of debt tend to be more accurate than pricing of equity. Hence, considering asymmetric information is crucial as to understand the financing behaviour of firms, especially in terms of smaller firms that are not publicly traded due to the lack of public data available.

### 3.4.4 Additional Determinants Influencing Capital Structure Choices

The choice of capital structure does not only depend on the firm’s preferences for debt or equity, as the empirical research available suggest that there are several additional factors that determines the optimal capital structure of the firm. In relation to the study at hand, it is important to introduce these factors and the implications to firms’ lending needs that might follow. Significant for studies on capital structure theory is the main emphasis upon the implications of firm-specific characteristics on capital structures and debt policy decisions of managers. However, increasing attention has during the last decades been given the industry-level characteristics and country-specific elements of the economic environment of the firm, and the subsequent effects on capital structures. Hence, the authors of this study find an
incorporation of a discussion regarding such parameters to be of essence in relation to the thesis at hand as to understand the financing behaviour of Swedish SMEs.

Bradley et al. (1984, p. 869) suggest that the variability of firm value, the size of non-debt tax benefits, and the scale of financial distress costs have great influence on the determination of an optimal capital structure for the firm. While firm value and financial distress costs are often discussed in capital structure theory, the existence and implications of non-debt tax benefits is less evaluated. That is, the type of assets held by the firm will come to have certain effects on the tax benefits available, and might thus indirectly steer the chosen debt level. Bradley et al. (1984, p. 874) argued for a negative relationship between such non-debt tax benefits and leverage ratios as in their study, firms with a significant amount of tangible assets tend to have higher financial leverage. Bradley et al. (1984, p. 869) also identified certain empirical evidence regarding the impact of industry commonalities on observed capital structures. Strikingly, industry classification showed to have a significant explanation power in terms of variances in leverage ratios, even when regulated sectors were excluded from the model (Bradley et al., 1984, pp. 869-870). Hence, as firms within a specific industry naturally come to hold similar asset structures a close connection is seen between internal and external determinants to debt ratios of the firm.

The findings of Bradley et al. (1984) were however not supported by Titman & Wessels, (1988, p. 11) whom saw no significance among non-debt shields and leverage ratios in their study. Rather, the authors found unobservable attributes to have strong statistical significance, as the results of their model suggested that a firm with unique characteristics and specialized products have lower debt ratios. Thus, keeping the purpose of the thesis in mind, these findings of Titman & Wessels (1988) do contribute with certain guidance as to explain the importance of factors and determinants that in some way influence the capital structure of the firm. Additionally, Titman & Wessels (1988, p. 14) suggests that the structure of loans tend to differ with firm size, as smaller firms are more likely to take on short-term debt than long-term debt. The reason might be seen in the level of transaction costs imposed on firms, as it becomes costly for small firms to take on long term loans. As a consequence, in contrast to the general assumption, transaction cost might play a decisive role in the choice of capital structure, especially for the small firm (Titman & Wessels, 1988, p. 17).

Through an empirical study based on a data set of Dutch unlisted SMEs, Degryse et al. (2010, p. 441) found the capital structure to vary across industries, suggesting that internal firm-level factors cannot solely explain all the variance in debt-ratios among the sample firms. Degryse et al. (2010, p. 442) suggest that the level of competition within the industry segment highly correlates to observed capital structures. Though, in terms of industry-level determinates to capital structure the empirical literature has predominately been based on data regarding large firms (Degryse et al., 2010, p. 431). Hence, as noted by the authors, the empirical research regarding SMEs is always somewhat restricted due to the lack of available data.

However, owing to these restrictions to the availability of data, research tends to be predominantly based on information from large corporations, operating in countries with well-developed capital markets. As a result, capital structure theory and models are essentially constructed as to explain the determinants of the financing policies and debt ratios for large firms. The lacking of publicly available data therefore enforce certain constraints to researchers as pointed out by Hall et al. (2004, p. 712), whom indicated a significant gap in the literature regarding international differences in capital structure of SMEs.
3.5 Theoretical Framework

The theoretical framework is constructed in regards to the research questions of the thesis at hand, and the different theoretical fields touched upon are tied together in a manner such that the reader will understand how the different sections relate to and affect each other. The main fields within in the framework that represent the foundation to the research at hand are Banks, Credit Risk, Capital Structure, SMEs and Rating Agencies. Further, the arrows displayed in the framework show on how the different theoretical fields are interconnected, and the different theoretical concepts are highlighted in separate nuances as to facilitate the overview of the theoretical framework. In addition, there are also areas that affect the main theoretical fields, which are presented in accordance of how they are related with the main subjects.

The framework is to provide insight as of how theory is to aid the authors of the thesis in order to answer the research questions. The theoretical framework will also be used as to establish the questions for the semi-structured interviews. It will work as a support to the authors of the thesis as to stay within the intended research subject. As the thesis at hand is of an exploratory design, the authors do not know in advance what the findings will be, thus the theoretical framework is later helpful to confirm that all relevant areas to the research has been touched upon in accordance to the empirical findings in order to later draw conclusions.

Figure 3.5 Theoretical Framework Developed by the Authors
Source: The Authors
4. PRACTICAL METHOD

The purpose of this chapter is to in a detailed manner present the different selections used in order to obtain the empirical data. The chapter starts with a description of the collection of data, the different selection criteria and how the authors gained access to the respondents. Continuing, the authors of the thesis discuss the preparation and conduction of the interviews and later in the section how the empirical data were to be coded and analysed. Lastly, the quality of the thesis is evaluated by different quality criteria and the chapter ends with a debate regarding ethical considerations.

4.1. Data collection

There are three different ways of coordinating interviews, structured, semi-structured and unstructured interviews. Structured interviews are often based on standardized questionnaires where every question is read out loud and the participant’s answers are typically recorded through a schedule with pre-coded answers (Saunders et al., 2012, p. 374). Continuing, the authors stated that the objective of structured interviews is to gather quantifiable data and therefore often is referred to as quantitative research interviews. Further, in semi-structured interviewing as emphasised by Saunders et al., (2012, p. 374) the scholar will have a list of subjects and key questions to be discussed. In light of the semi-structured interview approach the scheme of the questions might also vary depending on the flow of the discussion, and some questions might even be omitted. On the other hand, the semi-structured approach enables the researcher to add additional questions in order to explore the topic discussed given the specific situation, ensuring that all the data that is needed can be obtained. Lastly, unstructured interviews, also called in-depth interviews, are the most informal way of conducting interviewing. Saunders et al. (2012, p. 375) stress that in such interviews questions are not predetermined and thus the unstructured approach gives the respondent room to speak freely about a given topic.

In regards to the thesis at hand, the authors decided follow a semi-structured approach to interviewing, as structured interviews was believed to leave little room for the respondents to speak spontaneously about the subject. Further, a semi-structured approach with predetermined subjects and questions perfectly fits the aim of the thesis as the authors wanted to be sure to include all relevant themes in the interviews in order to later be able to answer the research question. For the same reason the unstructured interview approach were deselected. Also as stated by Saunders et al., (2012, p. 378) the semi-structured approach is appropriate when doing exploratory research and it is likely that the researcher will encompass semi-structured interviews. Continuing, as semi-structured interviews still leave room for the respondent to speak freely and also gives the authors of the thesis possibility to add questions if needed. This is in line with the narrative strategy of the thesis, as a smaller sample of participants will be selected in order to collect more in-depth information.

There are also different approaches to semi-structured interviewing, explained by Saunders et al., (2012, p. 375) the most common are face-to-face interviews, telephone interviews and Internet interview, but the approach could even occur in focus groups. The authors of the thesis selected to do face-to-face interviews with all the participants, this in order to ensure that all the interviews were conducted in the same way, as mixing face-to-face interviews with e.g. telephone interviews might have resulted in biased data.
4.1.1 Sampling Criteria

As emphasised by Rowley (2012, p. 262) “The findings of your research depend critically upon your selection of interviewees”, it is therefore important to establish a simplified profile of the interviewees in order to select relevant individuals. Further, Saunders et al. (2012, p. 260) suggest that it is often difficult to obtain data from a whole population and as a result the researcher needs to establish a sample. Thus, when the authors of the thesis at hand made their assessment of interviewees, specific criteria and limitations were taken into consideration.

A criterion for the interviewees taking part of the research was that they needed to be situated and work for a bank in Sweden. Also, as the authors were to conduct face-to-face interviews the participants needed to be located somewhere in the northern part of Sweden. Secondly, in relation to the research topic, the banks were required to have a corporate department issuing loans to firms, as to facilitate the retrieval of relevant information regarding the lending process. Continuing, the authors of the thesis argue that the individuals being interviewed should work at the same position within the organizations, as advisors are the ones working closest to the firms and also are the ones granting the credits. As a result, the authors selected corporate advisors to represent their sample. Correspondingly, as the aim is to evaluate the criteria used for granting credit to SMEs, the authors of the thesis required the corporate advisors to particularly work with this type of clienteles as to ensure to acquire relevant knowledge, but also to certify the comparability of the results. The authors of the thesis considered interviewing corporate managers as well but as the authors could not ensure to what extent the managers are in contact with SMEs, limitations were set to the advisors only.

Emphasised by Bryman & Bell (2011, p. 176) there are two different approaches in terms of sampling, the probability sample and the non-probability sample. The authors explain the probability sample as “A sample that has been selected using random selection so that each unit in the population has a known chance of being selected”. On the other hand, non-probability sampling is a sample method where some parts of the population have a higher probability of being chosen than others (Bryman & Bell, 2011, p. 176). In regards to the thesis at hand, the authors selected to use a non-probability sample method, as explained above, the authors had several requirements on the respondents who participated. As a result, different individual within the bank were deselected, as they would not provide appropriate knowledge to the research and thus, the likelihood of being selected is not equal.

There are mainly four approaches affecting the non-probability sampling method, quota, purposive, volunteer and haphazard (Saunders et al., 2012, p. 284). Starting, the authors describe quota as a sample commonly used within structured interviewing and are often used as an alternative to probability sampling when there is trouble acquiring data quickly enough. Purposive sampling allows the researcher to select a sample of participants based on what he/she believes is most appropriate for the research in order to answer the research question (Saunders et al., 2012, p. 287). Continuing, volunteer sampling, where the participants not are chosen for the research but rather they are volunteering themselves, is often used when it is troublesome to assessing individuals within the desired population (Saunders et al., 2012, p. 289). Lastly, haphazard sampling refers to a sample conducted without any clear guidelines of preference, as the participants selected commonly are chosen due to that they were most convenient to include at the time. In order to be able to answer the research question, the authors need specific knowledge concerning lending to SMEs, as this can only be assessed from a limited group of people within the financial institutions, the purposive approach enables the authors to select relevant individuals.
The authors of the thesis used the Internet to visit the different prospects’ websites in order to determine which of the banks who fulfilled the demands. As stated by Marshall (1996, p. 522) “An appropriate sample size for a qualitative study is one that adequately answers the research question”. Continuing, Barusch (1999, p. 422) emphasises that a small selection of respondents can be of great value if the information obtained is rich. The authors of the thesis were able to procure ten respondents that qualified to comply with the criterion mentioned before. The authors argue that a sample of ten participants might appear small, but as there currently are not many banks with individual departments handling corporations, and as the authors succeeded to assess five of the six largest banks in Sweden, the sample would provide adequate information and validity to the thesis. Also, as the respondents participating obtain specific expertise in regards to the subject, the authors of thesis received deep knowledge. Hence, the authors believe that the sample is sufficient enough in terms of providing relevant information to be able to answer the research question. Though, in order to assure anonymity no further information will be presented regarding the respondents and the banks.

4.1.2 Negotiating Access

As the authors of the thesis wanted to ensure that they would obtain relevant respondents, they started very early in their research process to establish contact with the different banks. Since the answers from the selected respondents were to represent a major part of the thesis, ensuring to attain appropriate respondents were utmost important for the authors, as if not, the research in question would not been possible to conduct.

Saunders et al. (2012, p. 378) determine that people are more willing to be interviewed, compared to completing a questionnaire, particularly if the person finds the topic being of interest and of relevance to his/hers current work. As the topic of the thesis is similar to the everyday work of a corporate advisor the authors of the study hoped that the respondents would be keener to agree upon participating. Six banks in different cities in the northern parts of Sweden were contacted whereof five banks agreed upon participation.

The authors faced different attitudes towards their research, as not all of the prospects reacted positively being contacted by the authors. Saunders et al. (2012, p. 223) describe three different factors affecting negotiation of access with organisations. Firstly, the amount of time that is needed from the participant must be considered, as organisations prefer that the timeframe required is as short as possible. Thus, time constraints could have been an issue, as the advisor needed to set off time for the interview, which may not have been possible. Continuing if the topic is sensitive, organisations are less willing to participate as the results, which later are to be published, could be of disadvantage for the organisation (Saunders et al., 2012, p. 223). Hence this might have been another reason because the subject of the thesis at hand touches upon sensitive information as the banks’ evaluation processes not are transparent and publicly available. Lastly, Saunders et al. (2012, p. 223) stress the importance of confidentiality of the information provided and the importance of ensuring the anonymity of the participant and the organisation. When contacting the different prospects the authors were careful to make sure that they were clear about the purpose of the thesis and how the information from the interviews later were to be handled. The authors tried to be as available as possible if the prospective respondents had any questions before accepting to participate.

As the respondents began to accept to participate in the research, the authors of the thesis started to schedule the different interviews. It resulted in that the authors obtained one to four respondents from the five different banks who participated in the research. Preferable would
have been to have at least two respondents from every bank, although this was not possible due to troubles gaining audience with the appropriate individuals.

4.2 Interviews

Discussing qualitative interviews, Kvale & Brinkmann (2009, p. 16) suggest that “Because there are few pre-structured or standardized procedures for conducting these forms of interviews, many of the methodological decisions have to be made on the spot, during the interview”. Hence, not only must the researcher understand the subject to be discussed but also be aware of the different methodological options and interview techniques available. Mentioned by Kvale & Brinkmann (2009, p. 17) generating valuable information through interviews demands practice, and the quality of knowledge produced is highly dependent on the skills of the interviewer. Thus, the authors of the thesis found it important to prepare themselves in terms of interview techniques and different means of asking questions as to ensure that valuable information of high quality would be generated. Interviews are however not only to be formed following specific rules and pre-determined methods, as good interview research includes the ability of the scholar to be responsive as to adapt to diverse situations (Kvale & Brinkmann, 2009, p. 87). This is in line with the philosophical stance of interpretivism taken by the authors as much concern was given to the personalites and individual traits of the participants as to adapt to each specific interview setting.

4.2.1 Preparations

Saunders et al. (2012, p. 238) argue that an information sheet containing all required information ought to be conducted, and provided to all participants in advance to the interviews taking place. Hence, after the initial stage of negotiating access, the individuals who had confirmed their willingness to participate were sent thorough information regarding the study, the interviews, and the implications of participation as to ensure that all individuals gave their consent to take part of the study based on transparent and complete information. The information sheet seen in Appendix 1 was sent out to the ten participants of the study and was conducted in line with the requirements presented by Saunders et al. (2011, p. 239) within their checklist. The information sheet contained a brief summary regarding the background of the authors, the overall purpose of the thesis at hand and a statement as to why such a study is of importance. Further, the authors presented the requirements of taking part in the study and what was expected of the participants as to avoid any misunderstandings. It was also clearly stated that participation was voluntary, and that the participants had the right to withdraw at any point through the interview process. Lastly, the information sheet contained a detailed description as to how data would be handled by the authors, especially emphasizing that all participants had full anonymity and that the thesis was to become a public act.

Kvale & Brinkmann (2009, p. 130) suggest that a list of questions or topics to be covered within the semi-structured interviews should be provided to all participants. Along with the information sheet, the authors incorporated a set-up guide as seen in Appendix 2 providing an outline of the structure of the interview and the topics that were to be discussed. The authors chose however not to share any specific questions, as the aim of the interviews was to gain authentic, narrative stories regarding the discussed topic. This was also due to the fact that the authors wanted to avoid participants only preparing themselves to answer the pre-determined questions, and thus limiting the spontaneity of the answers obtained. Due to the fact that the participants could not prepare themselves the authors were able to confirm that the right interviewees were chosen. That is since if a participant did not possess relevant knowledge
this would have been reflected in the answers provided and the authors could have excluded this interview from the thesis if needed.

As described by Kvale & Brinkmann (2009, p. 70) “Informed consent entails informing the research participants about the overall purpose of the investigation and the main features of the design, as well as of any possible risks and benefits from participation in the research project”. Providing a consent form that is to be signed by all parties may help as to clarify the limitations of consent and offer jurisdictive protection in terms of confidential data that may be handled (Saunders et al., 2012, p. 239). As the participants of the study at hand were corporate advisors at Swedish banks, the authors were certain that sensitive information was to be discussed through the interviews. Hence, the authors of the thesis formulated a consent form in line with the suggestions of Saunders et al. (2012, p. 240) as to secure the anonymity and confidentiality of all participants as well as allowing for the authors at hand to analyse and incorporate the information discussed within the thesis at hand. The consent form in Appendix 3 was part of the information sheet sent to all ten participants in order for them to review the contract prior to the interview taking place.

Rowley (2012, p. 265) points out the importance of formulating questions in such a way that the participant will fully understand what is asked as to mitigate any possibility of confusion. Continuing, the author suggests that “In addition, questions should be checked to ensure that they: are not leading or have implicit assumptions; do not include two questions in one; do not invite ‘yes/no’ answers; are not too vague or general; and are not, in any sense, invasive”. Hence, extensive reviewing of methodological literature was conducted as to ensure quality of the questions developed by the authors of the thesis at hand as to reassure that valuable information was collected. Among others, Kvale & Brinkmann (2009, pp. 135-136) discuss different types of questions that the researcher may ask during the interview. The authors also suggest that interview questions ought to be short, simplistic and formulated as to fit a specific context. As the purpose of the thesis is to explore the research topic through an inductive approach focusing on gathering information through narrative interviewing, the authors formulated many open questions as to invite discussion. However, sometimes it was seen as necessary to include direct questions implying simple yes or no answers.

In terms of structuring the interview, Bryman & Bell (2011, p. 475) suggest that a coherent order of the topics to be covered should be formed as to enhance the flow of discussions. However, it is also necessary for the interviewer to be able to adapt as to how the conversation develops and alter the questions asked in accordance. As a result, the authors of the study at hand decided to formulate questions in regards to the four main subjects that were discussed as seen Appendix 4. Further no specific order was determined in advance but rather questions were asked as the conversations were going along.

As the thesis at hand is written in English, the authors came to discuss whether to formulate the information sheet, interview set-up and consent form as well as holding the actual interviews in English or Swedish. However, as all participants and the authors themselves are native Swedes, Swedish came to be the language used as to mitigate any possible linguistic barriers in terms of informing and interviewing the participants. Further, holding the interviews in Swedish was believed to encourage more elaborated answers. Also, as a variety of specific terms and concepts were discussed, holding the interviews in English could cause constraints as it was not reasonable to assume that all participants felt able to discuss freely such topics in a foreign language. Thus, the information sheet, interview set-up, consent form
and interview guide has all been translated into English by the authors as to be incorporated within the thesis.

### 4.2.2 Narrative Interviewing

Rowley (2012, p. 263) suggests that one hour is an appropriate length when conducting six to eight interviews, however, in terms of length the decisive factor is that sufficient and valuable information is gathered. As a result each interview was expected to take 60 minutes, however depending on the individual traits and willingness to speak of the participants each interview was allowed to continue until the topics had been discussed and the participants felt satisfied, as seen in Table 4.1.

**Table 4.1 List of conducted interviews**

<table>
<thead>
<tr>
<th>Bank</th>
<th>Participant</th>
<th>Duration of Interview</th>
<th>Date</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bank A</td>
<td>1</td>
<td>70 min</td>
<td>2015-03-11</td>
</tr>
<tr>
<td></td>
<td>2</td>
<td>57 min</td>
<td>2015-03-16</td>
</tr>
<tr>
<td></td>
<td>3</td>
<td>63 min</td>
<td>2015-03-18</td>
</tr>
<tr>
<td></td>
<td>4</td>
<td>45 min</td>
<td>2015-03-18</td>
</tr>
<tr>
<td>Bank B</td>
<td>5</td>
<td>37 min</td>
<td>2015-03-13</td>
</tr>
<tr>
<td>Bank C</td>
<td>6</td>
<td>42 min</td>
<td>2015-03-11</td>
</tr>
<tr>
<td>Bank D</td>
<td>7</td>
<td>52 min</td>
<td>2015-03-16</td>
</tr>
<tr>
<td></td>
<td>8</td>
<td>45 min</td>
<td>2015-03-16</td>
</tr>
<tr>
<td></td>
<td>9</td>
<td>49 min</td>
<td>2015-03-19</td>
</tr>
<tr>
<td>Bank E</td>
<td>10</td>
<td>50 min</td>
<td>2015-03-12</td>
</tr>
</tbody>
</table>

Source: The authors of the thesis

All interviews were held at the workplaces of the respondents such that the interviewees did not have to consider any difficulties or time constraints getting to a possible outside interview location. The interviews were held at the personal office room of the respondent, or in a conference room which allowed for a calm private environment without any distractions.

All interviews were structured in the same way where one of the authors of the thesis took on the role as the active interviewer asking the questions, whereas the other authors passively took notes without significant participation in any discussion with the participants. Continuing, Kvale & Brinkmann (2009, p. 155) state that “After the initial request for a story, the main role of the narrative interviewer is to remain a listener, abstaining from interruptions, occasionally posing questions for clarification, and assisting the interviewee in continuing to tell his or her story”. Hence, great emphasis was devoted as to present attentive listening skills and encourage the participant to speak and elaborate upon an answer without coming to interrupt him/her.

Saunders et al. (2012, p. 289) point out that the researcher must be able to gain the confidence of the interviewee as to retrieve valuable information and often additional clarification may be needed prior to the initiation of the interview. Hence, each interview started with a few minutes of briefing where the authors of the thesis had brought printed copies of the information sheet, interview set-up and the consent form. As suggested by Kvale & Brinkmann (2009, p. 128) the authors began by discussing the information sheet as to ensure...
themselves that the participant had taken part of and understood the material as a whole. Specifically, the respondent was informed about anonymity, confidentiality, his/her right to withdraw at any point, and that the interview was going to be audio recorded. The authors of the thesis also informed the participants that the thesis at hand was to be written in English and that the answers provided were to be translated. Further, the set-up of the interview was briefly reviewed such that the respondent would feel more comfortable knowing what was going to happen and how the interview was structured. Thereafter the consent forms were signed by all parties as to ensure legislative protection of the authors and the participants.

In order to encourage the participants to speak freely and get more comfortable in this specific setting, the authors of the study chose to start each interview by letting the respondents introduce themselves and describe their past experiences (Rowley, 2012, p. 266). Suggested by Kvale & Brinkmann (2009, p. 153) the narrative interview emphasise the different stories and thoughts accounted for by the participant being interviewed. Such story-like answers may come spontaneously during the interview, or as a reaction of interviewer provocation. The topic of the study at hand regards the credit risk evaluation of SMEs and throughout the interviews, the participants showed great interest in the subject and at certain points came to talk longer than expected which was highly appreciated by the authors of the study. As a result, throughout all interviews, the answers almost always came to be longer, richer and more complex than the initial question asked which was seen as an indication of quality (Kvale & Brinkmann, 2009, p. 164).

The interview guide presented in Appendix 4 was followed as to ensure that all subjects were discussed. In line with the arguments of Saunders et al., (2012, p. 391) more complex questions regarding the specific valuation processes of the bank and the criteria used were purposely asked during the second half of the interview when participants felt more comfortable. However, the order of the questions was continuously changes as to fit the development of the interview and to encourage narrative answers from the participants rather than to steer the answers into a specific way. Further, the authors did not strictly follow the interview guide as to state all questions as sometimes the participant came to elaborate on a topic such that more than one question were answered simultaneously. Kvale & Brinkmann (2009, p. 155) argue that the interviewer may actively ask questions attempted to evoke narrative answers, as well as together with the interviewee discuss a subject such that a story is formed. Though only in a few cases did the authors actively intervene as to lead the discussion back to the topic of the thesis at hand.

The different background and previous experiences of individuals will inevitably affect the way the interview conversation is perceived (Rowley, 2012, p. 266). Hence, the authors of the thesis decided to end each interview with a summary of the different topics and areas that came to be discussed during that specific interview as to ensure that what was accounted for by the interviewee was fully understood in a correct way.

4.2.3 Transcribing Interviews

According to Kvale & Brinkmann (2009, p. 177) “The quality of interviewing is often discussed, whereas the quality of transcription is seldom addressed in qualitative research literature”. Hence, providing a coherent presentation and analysis of the methodological choices made in terms of transcription is highly important to the authors of the study. Transcribing interviews involves the translation of a linguistic language into a written language sensitive to personal judgements and interpretations (Kvale & Brinkmann, 2009, p.
Interviews must be considered as social interactions containing body language, tone or facial expressions that cannot be fully described in text. As to ensure that all aspects of language, spoken and non-spoken were accounted for in the data collection, one of the authors also took extensive notes throughout the interviews as a complement to the audio recorded conversations that were transcribed.

Each interview was audio-recorded which allowed for careful transcription into text after all interviews were conducted. The benefit of audio-recording was that the authors of the study could replay the recordings several times as to ensure that all data was accounted for in the transcription. Kvale & Brinkmann (2009, p. 179) point out that video recordings also captures the un-spoken language of the participant which may be otherwise unforeseen. However, the authors of the thesis chose not to use video due to the fact that as little attention as possible was to be given the technicality of recording the interviews as to mitigate participants being distracted or intimidated knowing that they would be filmed. Each interview was transcribed into a separate document named in such a way that the authors could separate the different files without invading any confidentiality issues (Saunders et al., 2012, p. 550). Further, as to distinguish each individual talking, and the different subjects that was discussed, an internally formed line of coding was developed between the authors of the study (Saunders et al., 2012, p. 551). As a result, the authors of the study at hand were able to maintain consistency throughout the transcripts, and prepare the data for later analysis.

The authors of the thesis chose to carry out the process of transcribing together due to the time constraints faced. However, as mentioned by Kvale & Brinkmann (2009, p. 180) consideration was taken as to ensure that the transcription of data was done in a coherent way. Further, as to capture the different expressions of the participants, the authors of the study chose to recite all words, sounds, and pauses within the transcripts rather than only the spoken words. Kvale & Brinkmann (2009, p. 184) suggest a measure of reliability is to independently transcribe all interviews as to compare the outcome. Even though such a method might have proven valuable, the authors of the thesis found it impossible due to the time constraint.

4.2.4 Categorization and Coding

Charmaz (2006, p. 45) suggests that “Qualitative codes take segments of data apart, name them in concise terms, and propose an analytic handle to develop abstract ideas for interpreting each segment of data”. Continuing, Charmaz (2006, p. 46) argue that coding within Grounded Theory ought to consist of two main parts that is, initial coding and focused coding. Hence, as to be able to provide a coherent presentation of the empirical findings, the authors of the thesis found it necessary to employ a two-step method of coding data.

<table>
<thead>
<tr>
<th>Initial Sampling</th>
<th>Initial Coding</th>
<th>Focused Coding</th>
<th>Grounded Theories</th>
</tr>
</thead>
</table>

Figure 4.1 A summary of the Process of Constructivist Grounded Theory
Source: Saunders et al. (2011, p. 568)

The initial coding process as introduced by Charmaz (2006, pp. 47-48) involves the detection of actions within the data as to develop codes reflecting the content of the information without applying pre-existing theories or concepts. There are several means of sorting data into initial
codes, and explained by Charmaz (2006, p. 50) word-by-word coding relates to the procedure of relating each word to a specific meaning or image, and is specifically helpful when analysing Internet-data. Continuing, Charmaz (2006, pp. 50-51) argue that applying a code to each line of transcript may prove useful as to analyse rich, detailed data especially collected through interviews or observations. By instead detecting and comparing incidents within the data, Charmaz (2006, p. 53) suggest that the scholar may be able to identify specific context of an event. However, the author also stresses that for the unexperienced researcher, finding the underlying meaning of different actions may prove difficult.

The authors of the thesis at hand have collected a vast amount of rich data regarding a rather unexplored subject within empirical research. Hence, it is believe that employing an approach of line-by-line coding will prove useful as to identify initial categories of information. Also, coding the data line-by-line will enable the authors of the study to continuously compare the findings as to detect new valuable thoughts expressed by the participants (Charmaz, 2006, p. 53). As a result, each line of text within the transcripts was given a code representing the meaning of the content.

Charmaz (2006, p. 59) also argues that focused coding enables the researcher to analyse and compare the experiences, actions and interpretations of the participants. Hence, as to be able to present valuable empirical findings in a coherent manner, the authors of the thesis argue that it is necessary to develop a second stage of focused codes. Continuing, Charmaz (2006, p. 57) explains that “Focused coding means using the most significant and/or frequent earlier codes to sift through large amounts of data”. Thus, the authors of the study compared the initial codes as to detect commonalities amongst them and grouped these codes together into broader categories of the four focused codes presented in figure 4.2. However, due to the exploratory nature of the study, a vast amount of data was collected and hence the authors found it necessary to filter out information that was relevant in terms of the research topic.

![Figure 4.2 The Focused Codes Established and an Extract of Initial Codes](source: The authors)
4.3 Quality Criteria

When conducting qualitative research one of the major challenges is to assure that the research established is trustworthy, of scientific nature and of high quality (Eriksson & Kovalainen, 2003, p. 290). Saunders et al. (2012, p. 381) describe reliability, research bias, generalizability and validity as four different issues that the researcher needs to consider in the preparation and conduction of the research to assure the quality of the study. Embracing evaluation criteria throughout the research increases the transparency of the study, and aids the researcher to emphasise the strengths and limitations of the research (Eriksson & Kovalainen, 2003, p. 290). Further, the authors stress that, it is important to continuously evaluate these criteria during the research process and not only at the end of the study, this in order to ensure high quality of the adopted research. The authors of the thesis will below present a discussion regarding how they applied these quality criteria through their research.

4.3.1 Reliability

Reliability refers to the findings of the research, and its trustworthiness and consistency, this in terms of whether or not the findings can be reproduced by other researchers and at other times (Kvale & Brinkmann, 2009, p. 245). Continuing, Bryman & Bell (2011, p. 395) describe two different measures of reliability, external and internal. External reliability refers to which degree that the research can be replicated. Especially in qualitative research this is a difficult criterion to encounter, as the different circumstances and a social setting cannot be frozen (LeCompte & Goetz, 1982, p. 32). The authors explain that internal reliability regards, if there are more than one researcher, whether or not they agree of what they see and hear, thus, due they have the same perception of the findings. In order to confirm that the authors had interpreted the responses accurately, the authors of the thesis always ended the interviews with a short summary regarding the main themes covered during the interview. Another aspect in terms of ensuring internal reliability was that the authors of the thesis at hand during the whole research process discussed how to conduct and interpret information in order to avoid dissimilarity. As mentioned before, when conducting the transcription of the interviews the authors agreed upon an internally formed line of coding in order to maintain consistency.

In terms of interviewing, reliability reflects to if the interviewees would change their answers depending on the person interviewing them (Kvale & Brinkmann, 2009, p. 245) However, as argued by Saunders et al., (2012, p. 382) when conducting semi-structured interviews they may not necessarily need to be repeatable as the intention is to capture the reality at time it was collected. Thus, the authors of the thesis argue that the relevance of the external reliability criterion is quite low, since even if the authors would interview the same person several times, the interviews might yield different results due to the semi-structured approach to interviewing as what is discussed depends on the situation at the interview.

4.3.2 Research Bias

Interviewer bias pertain the tone, comments or non-verbal actions of the interviewer that in term might create biased answers from the respondents, as the interviewer may try to impose his/hers own beliefs within the question being asked (Saunders et al., 2012, p. 381). Continuing the authors determine that interviewer bias might also concern that the interviewer interpret the responses in an inaccurate way. As to avoid interviewer bias, the authors of the thesis selected the same author as the leading interviewer in all interviews in order to ask the questions in the most similar way feasible. The authors also tried to be as neutral as possible,
when asking questions the authors were careful to not interrupt and to encourage the respondent to further deliberate their answers in order to obtain a rich amount of information. Before the interview the authors were clear to state that there were no right answers as they were to explore the criterion used by banks, thus it is the respondent’s view that is “correct”, and as a result the authors tried to not put any value into the answers obtained as all answers were of as great importance.

Response bias is the kind of bias that may occur due to perceptions about the interviewer, which is important to not confuse it with the interviewer’s perceptions (Saunders et al., 2012, p. 381). The unstructured exploration of certain subjects may lead to other topics to be covered that the interviewee wishes not to discuss. As a result, the outcome might be that the respondent only provides a partial answer in order to present him-/herself and the organisation in a desirable way. Also, the respondent may want to avoid probing questions that he/she do not wish to deliberate upon a specific topic with the interviewer. To avoid this type of bias, the authors of the thesis clearly stated that all the participants were to be completely anonymous in the study and as a result the respondents would feel comfortable to speak more freely. Additionally, the authors explained for the respondents that they understood that the subject discussed is rather sensitive and that the respondents might not be able to answer all the questions due to confidentiality, but clearly stated that the interviewees always had the possibility to not answering the question. The authors hoped that this would have led to that the answers obtained were to be truthful and that the respondent had no objective to provide answers with withheld information.

Mentioned by Saunders et al. (2012, p. 192) is participation bias, which refers to participants providing falsely stated answers. This can be due to the respondent is feeling overheard if the interview is taking place in an open space, and as a result they do not feel sure about that their anonymity can be guaranteed. All of the respondents had the option to choose by themselves where the interview were to be held, as a result all of the interviews were held behind closed doors, in a conference room or in the respondent’s own office, hence the possibility of being overheard were eliminated. As the sample were not as altered as the authors had wished, minimizing the bias is extremely important, though, the authors still believe that they have a representative sample as five of the six largest banks in Sweden participated.

In terms of overcoming these types of biases Saunders et al. (2012, p. 383) provides a checklist for the researcher to consider before and under the interviews. The authors of thesis were careful to make sure to fulfil these criteria, as the information conducted from the interviews was to represent a major part of the thesis. Thus, it was important for the authors to be well prepared in order to obtain as much relevant information as possible.
4.3.3 Generalizability

Saunders et al. (2012, p. 382) describe generalizability in terms of the degree to which the findings established in the research are applicable to other settings. In qualitative research generalizability deals with well-argued and -grounded selection of people or research cases (Eriksson & Kovalainen, 2011, p. 293). Generalizability is often discussed in relation to qualitative studies, as it often is based on small samples and unrepresentative number of cases (Saunders et al., 2012, p. 382). Though, this does not automatically mean that quantitative studies are more generalizable, it all depends on the context of the study and the aim of the investigation. In regards to this thesis, the authors have been very thorough in their selection of participants, before anyone was contacted the authors made their assessment of the criteria for participating in order to establish that relevant individuals were to participate. The authors of the thesis argue that their results might not be one hundred percent generalizable, as the aim is to explore a relative new area to empirical research the research might function as a stepping-stone for further research. In order to generalize the findings, the authors would of have needed a larger sample with a greater geographical spread and a more equal distribution of participants from the various banks.

4.3.4 Validity

Svensson & Starrin, (1996, p. 210) stress that validity regards the measuring of how suitable the selected methods and structure of the study are. Eriksson & Kovalainen (2012, p. 292) emphasise that validity concerns “the extent to which conclusions drawn in research give an accurate description or explanation of what happened”. Bryman & Bell (2012, p. 395) describe two different ways of evaluating validity, internally and externally. The internal validity concerns whether the theoretical foundations match the researchers’ observations and the ideas generated. Argued by LeCompte & Goetz (1982, p. 43) internal validity is often considered to be the strength of qualitative research, especially concerning ethnographic research where a high level of congruence often is established between observations and concepts. Further, external validity concerns to which level the findings of the study can be generalized into different social settings (Bryman & Bell, 2012, p. 395). This is often a
problem in qualitative research due to small samples and the contextual settings of the research (LeCompte & Goetz, 1982, p. 44).

Regarding the external validity, as argued before the results might not be generalizable, also as the research is conducted in a specific context it might not be applicable to other social settings as the information was obtained at that specific time. Further, due to the semi-structured approach of interviewing, even if the same authors were to interview the same respondents the answers obtained may not be the same as the first time. Though, the authors stress that throughout the process they have been very thorough in their assessment of different methods and approaches applied to the research in order to achieve the best results possible. The authors have been very careful to make sure that all the selections regarding the research are well motivated and suit the study in order to fulfil the validity criterion.

4.3.5 Ethical Considerations

The balance between respecting the integrity of the respondents and at the same time striving to obtain as much knowledge as feasible is not an easy issue to deal with (Kvale & Brinkmann, 2009, p. 174). The authors describe this as “the interviewer’s ethical dilemma” where the risk of violating the interviewee’s personal space is weight against the risk of obtaining information that only scratches the surface. Further, the authors explain that this type of dilemma cannot be solved solely by ethical guidelines as the dilemma is highly dependable on the researcher's judgement and ethical experience. Evaluating the quality of the interview is not a standardized process, there are no pre-determined criteria that assure a qualitative interview, and it all depends on the specific context of the interview as the topic, form and purpose (Kvale & Brinkmann, 2009, p. 175). With this in mind, the authors of the thesis at hand will deliberate how they have handled different ethical situations in regards to their particular research.

Saunders et al. (2012, p. 226) explain that ethical issues permeates the entire research process and emerge as the researcher plans and design the research, seeks access to participants, collect, manage, analyse and report the findings. The authors emphasise that ethics refers to the principles of the conduction in relation to the individuals affected by the research. In other words, the researcher requires establishing that the research does not affect the participants in a negative way. As to fulfil these demands, the authors of the thesis are careful to ensure anonymity of all the participants so that no sensitive information about the organisation of the participant is presented. In line with the deontological view adopted by the authors, the authors established the juridictive consent form as a guarantee to the interviewees to make sure that they are to be unaffected by the research and kept anonymous.

As mentioned before, as to later be able to analyse the information gathered from the interviews, the authors of the thesis selected to audio record the interviews. The authors enlightened the participants in advance that the interview were to be recorded, but the interviewees also needed to sign the informed consent form, where they accepted to be audio recorded before the interview could start. This is in-line with the recommendations of Saunders et al. (2012, p. 396) as the researcher needs the permission of the respondent in order to audio record the interview. Though, the authors were careful to state that the interviewee always had the option of ending the interview at any time if feeling uncomfortable.
Saunders et al. (2012, p. 247) discuss different principles the researcher needs to consider in order how to protect and manage data, both ethically but also lawfully. The authors stress the importance of how the researcher handle the data after it is collected, it is central that it is kept securely and not longer than necessary and that the data obtained later is destroyed in a secure way, e.g. not just throw the informed consent forms in a bin, but rather destroy them in a shredder (Saunders et al., 2012, p. 248). As a result the authors of the thesis at hand has taken these requirements into consideration when handling the sensitive information obtained, firstly, the data files with the audio recorded interviews has been kept save on a memory stick with password and coded filenames in order to guarantee the safety of the recordings. Secondly, the authors of the thesis will destroy all the material after the analysis is done as to establish that no sensitive information is to spread, as it is utmost important for the authors to keep what they have promised to the participants in terms of their anonymity and not being harmed in any way due to their participation.

The authors of the thesis chose to hold the interviews in Swedish, and consequently translate the answers into English as to be able to present the empirical findings. Thus, another ethical aspect that needed to be taken into consideration was the possibility of bias when translating the interview material and that the intended meanings of the responses given by the participants were not twisted in any way. The authors are aware of the different implications that translating the answers might have on the resulting findings, and that it is rather difficult to hedge against unintentional or accidental errors. However, the authors argue that this problem could to some extent be reduced seen as the authors of the thesis are both fluent in academic English.

In order to further mitigate possible bias and ethical issues, the authors of the thesis were clear to inform the participants before conducting the interviews that their answers subsequently were going to be translated into English. Continuing, as the authors of the study wanted to be able to incorporate citations of the participants this was also mentioned within the Consent Form that was signed prior to each interview. By doing this the authors could be sure that the participants were aware of how the data was to be presented within the thesis and that they agreed upon being cited. It was also explained that the participants would get a copy of the final version of the thesis, in order to give the participants the opportunity of reviewing their contributions. However, the authors would like to direct certain criticism against themselves, as the information provided regarding translation of the thesis and the possibility for the interviewees to review their answers could have been even clearer. An alternative would have been to state this information within the Consent Form as to avoid any possible misunderstandings and unnecessary ethical issues.
5. EMPIRICAL FINDINGS

Within this chapter, the authors of the thesis at hand will start off with a short introduction of the participants and how the anonymity and confidentiality of these individuals will be handled. The empirical results will thereafter be presented in accordance with the developed codes discussed in chapter four, starting off with the clientele of the participants followed by a description of different criteria mentioned. Lastly, the process of credit risk evaluation and a discussion of the overall assessment will be reported.

5.1 Presentation of Financial Institutions and Participants

In order to present the findings without revealing the identities of the banks and the participants, the pseudonyms seen in table 5.1 will be used. The authors of the thesis chose to name the banks without any specific order in mind, following the first letters of the alphabet. Thereafter, the interviewees were numbered following the order of the banks and in the case several individuals represented the same bank, these participants were numbered randomly.

Table 5.1 List of Pseudonyms

<table>
<thead>
<tr>
<th>Bank Pseudonym</th>
<th>Participant Pseudonym</th>
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<tbody>
<tr>
<td>Bank A</td>
<td>A1</td>
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<td></td>
<td>A2</td>
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<tr>
<td></td>
<td>A3</td>
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<tr>
<td></td>
<td>A4</td>
</tr>
<tr>
<td>Bank B</td>
<td>B5</td>
</tr>
<tr>
<td>Bank C</td>
<td>C6</td>
</tr>
<tr>
<td>Bank D</td>
<td>D7</td>
</tr>
<tr>
<td></td>
<td>D8</td>
</tr>
<tr>
<td></td>
<td>D9</td>
</tr>
<tr>
<td>Bank E</td>
<td>E10</td>
</tr>
</tbody>
</table>

Source: The Authors

5.2 Findings

The empirical findings of the semi-structured interviews are presented in accordance to the developed codes discussed in chapter four according to the methodological choice made of a Grounded Theory approach to research. Thereafter, each section has been arranged in line with different themes this is as the authors of the thesis found it important to provide a coherent and structured recounting of the information provided by the participants. Further, the authors of the thesis aimed to retell all information in such a way as it was delivered during the interviews by the interviewees as to avoid possible bias in line with the ontological stance of constructivism as the authors of the study believe it important to care for the individual expressions of each participant.
5.2.1 Clientele

Quantified Measures

Some of the participants quantified their customers in terms of size measures, among them A2 reported a customer base ranging from firms with a turnover of 10-200 million SEK. In contrast, the turnover of the clients held by A4 was smaller, varying from 1-80 million SEK. Both D7 and D8 described in detail their target clientele to be constituted by companies with a turnover between 25-500 million SEK, though their actual customers were smaller with a turnover from 1-400 million SEK. Further, D9 quantified the turnover of the clientele to be around 20-250 million SEK. E10 was the only participant discussing size in terms of the number of employees of the corporate customers rather than turnover, stating that the clientele were preferably comprised by firms with up to eight employees. A more general discussion regarding the size of the clientele was provided by the others. Among them C6 stood out by describing the clientele as to mainly contain the wealthiest firms. Further, C6 also said that the customers were small in the sense that no firm was publicly traded, however it depended as to how one is to view size and within which context.

Industry Specifics

All the participants were equal in the sense that the clientele is spread out through several different industries. A small difference can be seen in terms of the industries of the advisors clientele depending on the geographical location, where manufacturing firms were more common for participant A3, A4 and D8, whereas, operating firms and retail businesses were more common for the others. One common industry that reoccurred under the interviews was the real estate business, as stated by D7 “Of course all banks work with real estate companies”. Continuing, D8 believes that meeting one customer creates a ripple effect, that industry colleague seeks contacts and thus affects the customer base.

It was also evident to the authors of the thesis that all participants except one explicitly pointed out the importance of considering different specifics of the industry in which the firm operates when evaluating credit risk. Cited by D8, “Well, you try to gain some kind of apprehension regarding a specific industry and let us say ‘industry A’ with zero and none possibilities for export, then you will probably be more restrictive as to grant loans to firms within that industry”. Further, B5 explained the level of competition within different sectors to be a factor that the bank takes into consideration and that it is something that the advisor has to assess when making a credit decision.

Continuing, B5 suggests that “It is also important as to assess the overall risk level within the specific industry in which the firm operates, which type of industry it is and is this an industry that we want to do business with?” The authors of the thesis were also told by many of the participants that the restaurant sector was seen as a red flag, and commonly not a desired market by the banks. According to C6, the type of industry in which the firm operates may also affect what ratios, which become important to look over during the risk evaluation process. D7 described to the authors of the thesis, that is important to consider other specifics of an industry such as the level of regulation, or if companies operating within that sector tend to highly reliant on governmental aid.
Geographical Spread

Many of the participants recounted of a rather small geographical spread of their clientele, mainly working with companies within the local area. Specifically, B5 said that 95% of the clientele was companies from the same city as in which the participant worked. A4 has a clientele consisting of companies spread out over the surrounding municipalities whereas in contrast, A2 primarily is working with companies situated within the near area. A3 discussed the geographical spread of the customers in terms of the “church tower principle” suggesting that “We should preferably do business from the area which you could overview from our church tower, so if you would climb the tower and gaze out, that is our local market”. Such a similarity was also seen among the participants within Bank D, where the clienteles commonly was locally based however stretching out to the surrounding municipalities within the county. However as mentioned by D7, the main objective is to focus on companies in the coastal cities in the north of Sweden, as the growth opportunities in the hinterland areas is rather restricted.

5.2.2 Criteria

The Individual

When discussing the different criteria used by banks to evaluate credit risk of SMEs, one criterion that reoccurred during all interviews was the evaluation of the owner of the company Citing B5, “First and foremost when assessing credit risk, what we evaluate is the owner, is this a person that we believe in?” Continuing, the same participant explained that qualitative measures is on top of the bank’s evaluation list and even though the financial statements and the historical data looks great, if the advisor do not believe in the person he/she speaks to, the firm will not be granted credit. Further discussed by participant D8 “Sometimes the decision of granting credit relies on criteria based on individual traits, do we want to work with these people”. A3 elaborated that in the credit granting decision of course all the formal requirements needs to be fulfilled and that over time is has become more evident that the assessment is highly dependent on the individual managing the firm.

When asking the participants of special characteristics that a successful owner should possess, more than half of the participants explained that it is hard to pinpoint specific features and that you rather get a gut feeling of the person in front of you seems reasonable. As told by participant E10, “You need to assess what kind of person that you have in front of you, after doing this for several years it gets easier to trust your feelings”. This argument was supported by A4 that explained that it is hard to assess specific characteristics of a person and that it is crucial to try to maintain an objective point of view when evaluating the owner. Because it is important that the customer gets a fair evaluation as trusting your gut feeling is rather subjective as it emphasize the advisor's point of view. Continuing on the same discussion, participant A3 were clear to state to the authors of the thesis in a very open and honest way that we all are individuals and of course we get along better with different people than others. Furthermore the participant argued that it is important as an advisor to give the customer alternatives, as to meet with another advisor if the advisor feels he do not get along on a personal level so that the customer do not suffer because of this. The interviewee stated that as long as the advisor feels that the owner pass the gut feeling, the bank will always find a solution for the owner to obtain credit. D8 was on the same page and deliberated that even though a firm do not have the flawless key ratios as the bank wishes for, as long as the owner
of the firm can explain why this is, what the goal and outlook for the future is and it seems reasonable the bank can take on the deal.

**Individual Characteristics**

Some of the participants mentioned different key features of the individual that they believed to be of importance in terms of assessing the owner as summarized in Figure 5.1. As elaborated by participant **E10** preferable characteristics to possess for the owner are to be structured, driven and versed, “*As an advisor handling credit, I do not want to hear that problems that may occur will be manage in some way, I want to know how the customers will handle different situations and thus that they have done their homework*”. Continuing, interviewee **D8** explained that usually when evaluating an individual the advisor assesses if it is a strong person with passion and drive and also what kind of track record the individual has. In terms of the smallest firms with only one owner, participant **E10** further discussed that the individual owning the firm becomes extra important in these cases as that person are the one to both operate and manage the company to either failure or success, this was also supported by **A4** and **D9**.

![Individual Traits]

Figure 5.1 Summary of Individual Traits Discussed by the Participants  
Source: The Authors

**A4** explained to the authors of the thesis that it is preferable if the owner also has its personal finance in the same bank, as the policy of the bank is to the largest extent possible make sure that the owner is a customer of the bank. This in terms of be able to see the overall picture and in that way create solutions that advantageous to the customer, also it can be beneficial for customer in terms of a more advantageous pricing. Cited by **A4** “*We take all aspects of the customer into consideration when granting a credit, and it is important for us that we will be able to provide other services such as insurances or pension funds. We do not want to solely lend out money and nothing more*”. This reasoning is backed up by **C6** whom stated, “*It is not a disadvantage because then they have a need for bank services, as if you are a smaller firm then you often just need a credit card and a small credit line*”.

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Another characteristic of the owner brought up during the interviews, was the risk profile of the customer. Participant A2 discussed that before starting an errand it is important to get to know the customer, the business and to assess the risk profile of the customer. Continuing, the same interviewee explained that most entrepreneurs are prone to take risks and as banks do not provide venture capital it is important to assess the risk profile of the customer. Participant E10, argue that assessing the risk profile of the customer is an important feature in the credit risk evaluation process.

The owner’s previous experience and knowledge was something that a couple of participants brought up during the interviews as a characteristic influencing the judgment of the owner. Participant D9 explained to the authors of the thesis that an important criterion for evaluating the individual is to assess what kind of knowledge and what kind of experience the owner possess. B5 also discussed these characteristics and stated, “Which competence do you have and what have the owner done before? Is it somebody who never have run a business before and what kind of experience do the owner possess?” The same interviewee further developed the argument and clarified that the owner and his/hers characteristics is of great importance in the credit granting process. D8 supported the arguments of D9 and B5 as the participant emphasized that drive, knowledge and experience are the distinctive features of the owner that the participant assesses in the evaluation.

Both A1 and D7 explained to the authors of the thesis at hand that they found it troublesome to specify specific features of a person that inevitably make them good owners, and that it is rather a feeling that you get from an individual’s personality. Although, after some thinking A1 started to mentioned characteristics such as drive and awareness as attributes that may affect the evaluation of the owner in a positive way. Further A1 affirmed, “Less successful entrepreneurs are the ones always blaming their lack of success on external factors”. Participant D7 also tried to pinpoint some features and the discussion mostly revolved around the reputation of the owner. D7 further mentioned to the authors that as an advisor you hear rumours as they spread fast, and of course you will assess what kind of reputation does the owner have and how is the firm perceived, as a bad reputation can majorly harm the customer’s business in the future. However, as said by D9 “It is not specific attributes that will make or break the evaluation of the owner, it is rather the overall impression and the kind of feeling you get when talking to the individual”. In a similar way this was also emphasized by the other participants that discussed specific attributes when assessing the owner of the firm, that an individual will not be neglected due to that the person lack a specific characteristic, hence the general impression of the individual is what matters the most. Interviewee A3 elaborated “We are both humans, if I believe that it is beneficial for the bank to grant you credit, then I will grant you credit”.

Key Individuals

Another important criterion concerned key individuals within the firm, where almost all of the participants mentioned that this is a feature that they take into account when evaluating credit risk. Participant C6 explained that an important feature in the credit risk assessment of the firm regards the key individuals of the company, as the participant further argued, “The individuals running the company is very important to the success or failure of the firm”. The argumentation is supported by both D7 and D8, where D8 deliberated that the qualititative judgment of the firm is largely based on the individuals operating within the firm. The same participant further stated that it is important to assess who these individuals are and their
previous experiences. During the interview with D7 the authors were told that sometimes a firm can be very profitable but with the wrong owner or management the whole firm can become overturned, thus the key individuals are very important in regards to the credit risk assessment. In the discussion with A3 it was also stated, “Still, it comes down to the people within the company that I work with, these are the ones who in the end will make a difference”.

In a discussion regarding SMEs A4 pointed out to the authors of the thesis that the owners of the firm are an important criterion in the credit risk assessment as they are the ones running the firm. Besides the owners the same participant described that it also is important to assess if there are other key individuals that might affect the firm in some way. In the interview with A1, the interviewee explained that it always comes down to the individuals of the firm, “If it is the people behind the firm that is the most important feature of the company, then at larger exposures we usually make separate agreements where as the key individuals are tied to the credit. If they drop out, then the credit granted to firm will be laid off”. A2 were not as précis as the others but concluded that for smaller firms the operations and the key individuals are important criteria in order to assess the credit risk.

Relationship

During several of the interviews a discussion regarding the relationship between the customer and the bank occurred. C6 explained that the bank’s objective is to do business with customers that they can build long and sound relationships with. Bank C works according to the “church tower principle”, and C6 described that they prefer to do business with customers within reach of the church tower. This is due to that the bank believes that they can get to know the customer better if the firm is closely located, this in order to create long-term relationships and as a result create conditions to make sounder credit risk evaluation decisions.

A4 and B5 discussed existing customers versus new customers. Both of the participant stated that there is no difference on the criteria they look upon in their evaluation between the two. However B5 explained, if the bank knows a customer from before e.g. the customer have had a private bank account, the credit risk evaluation process might be slightly more at ease for an existing customer compared to a new customer. Continuing, the same interviewee deliberated that much is due to the fact that the bank then have a history to assess, therefore the bank requires higher standards for a new customer as they have less information to base the decision on. A4 was on the same page and stated, “However, we would rather help an existing customer if there is something negative within the firm than an owner that we don’t know”.

During the interview with D7 the fact that the credit risk assessment can be simpler if it is an existing private customer came to the attention of the authors. Though, the interviewee emphasised that if the customer is a customer since before it does not automaticity imply that it is a good customer, however, if there is an existing relationship then the bank and the customer already know each other which can facilitate. As an example D7 explained that if there are two equivalent customers, one of which is an existing customer and the other one is not, reasonably, it will be easier for the existing customer to be granted credit. Quoted by the same participant, “It is important with contacts, so is the case with everything regardless of industry”. The reasoning was supported by A1 who explained to the authors of the thesis at hand that one of the criterion among others used in the assessment of credit risk is the relationship with the owner/firm.
Participant A2 described that usually the relationship between the bank and the customer is damaged if the customer who is seeking credit has been a customer for a long time and the business has started to be unsuccessful for a while. As a result the customer usually seeks other financiers, the same participant further stated, if the trust between the two parties has been violated, commonly the best thing to do is to end the business collaboration.

External and Internal Discipline

In terms of discipline, A1 explained that while a single defaulted payment is not necessarily decisive, a tendency of continuous failing discipline towards the bank might lead the company into trouble. Moreover, A4 said that “We really consider the internal discipline because if that is inadequate, that is kind of the first thing, the firm must really have been managed well and that the owner has not previously misbehaved towards the bank, as for us to be willing to lend out money”. Managing your obligations towards the bank will have a positive effect on the internal rating classification of the company set by the bank according to E10. Well-managed companies without any payment notices will climb the bank’s internal rating and be considered as to have lower credit risk. It was also mentioned by D8, that it is often easier to borrow money for an existing customer that have showed a clean record towards the bank, than for a new start-up without any historical evidence to base the credit risk evaluation upon.

Cited by D9 “If the firm is an existing customer in the bank, then you might probably be aware of how the firm have managed its operations and not overdrawn its budget”. The participant also said that if the bank sees that a firm is severely externally undisciplined, with several defaulted payments showing in the credit reports, the bank will probably not support any further business with that firm. However, if there is an existing firm coming from another bank, the new bank cannot detect any internal misbehaviour towards the previous lender, and in that case D9 explains that is difficult to assess the level of discipline. Continuing, A2 described external discipline as an important factor affecting the internal rating model as each defaulted payment will show up negatively influencing the classification. If the owner or the firm has been a customer at the bank before, the internal historical discipline will also be evaluated. Further, A2 clearly explained that the personal finances of the owner has no significance to the bank, but might however have an indirect effect on the firm especially in the case when the firm is a sole proprietorship. These arguments were supported by A3 and C6 who additionally expressed the importance of managing both you private and your company’s finances.

Apart from behaviour and financial discipline, transparency towards the bank was also seen as something important by some of the participants. Among them D9 said that “Of course we prefer to be informed if the business is not profitable”. If you are open and notify the bank in times when business is not good, the bank might be more willing to help you in the future. This was also confirmed by D8, who stressed the importance of being honest and open about yourself, your company and your history within different businesses. Continuing, the participant said that there are many business owners that do not fully inform the bank about everything therefore arguing that “I usually say that the truth will always be revealed sooner or later, never lie”. The issue of transparency was furthermore discussed by A2 whom told the authors of the thesis about a customer that had filed bankruptcy a while ago. However this customer had throughout the process been very open towards the bank and managed the situation in such a way that the bank was willing to provide further financing. Concluding the story A2, stated that “If the customer had not been transparent and open towards us, we
would definitely not have been interested in lending out any more money to that firm as to get business going again”.

However, as mentioned by some of the respondents, it is also important that the business owner provides the corporate advisor with credible material and explains as how she/he will manage the firm. A1 said “After all, we emphasized the credibility since there are many owners that provide great material but however are unable to sell their idea”. Further, the financial expectations expressed in the budget must also be credible and reflect the reality. D7 said that “Some people will show the expected growth as a classical hockey-stick”. It is necessary to remember that no business will follow a straight path. Rather, if the owner shows a slightly less promising budget, the bank might actually find it more credible.

Contracts with Customers and Suppliers

Another aspect to the evaluation that came to be mentioned during a majority of the interviews was the level of stability and diversification in the relationships with customers and suppliers as well as maintaining strong contracts with different stakeholders. As cited by D7, “Needless to say, you will inevitably look at factors such as the type of customers, it is incredibly important to know if the firm has 1 or 10 customer you know, how large is the risk in the clientele of the firm”. Therefore, the bank might want to look over the accounts receivable the participant further explained. The importance of a diversified clientele was also stressed by B9. However as A3 further said, “It is also the ability of the firm to find new customers that are important”. Even though an existing clientele seem strong and diversified, the firm must be able to attract new customers as to remain profitable.

A larger firm must in some way be more formalized as it requires another level of management to get all the functions within the company to be efficient as to do business A1 described. Further, A1 said that “If you consider a larger industrial firm, their customers will be large manufacturing companies and then we of course need to know how these contracts are formed and how does the customer’s market look like? At what point in their business cycle do they operate? Does the company have international customers? That is some factors that we consider when making an evaluation”. It is important that the firm seeking a loan can exhibit a credible business by operating in a strong market with long profitable contracts with customers. The same reasoning was provided by B5, who also mentioned the customers of the firm seeking a loan as an important factor affecting the overall assessment of the company.

Discussing the implications that existing contracts may have on the evaluation made by the bank, D7 explained to the authors of the thesis that it might depend on the maturity of the loan. Property loans often have longer maturity, sometimes up to 50 years and in that case as cited by D7 “Then you want to see that the firm will have sufficient cash flows, maybe not for the whole duration of the loan, but take the coming 5 years, what contracts do they have? Will they generate income as to cover their interest payments and amortizations?” If the firm can demonstrate several long-term contracts with strong and stable customers, it will have a positive implication on the possibility of getting a credit approval by the bank D8 said. Further, several participants also suggested that contracts become especially important for a real estate company, as the bank may want to overview tenant lists as to see whether the company will be able to generate rent each month, as cited by D8 “If we are to grant a credit worth hundreds of millions SEK, we want to know whether the firm has a good clientele, you know, have underlying contracts”.

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D7 and B5 said that the relationship with suppliers also is something important that can have an impact on the profitability of the firm. However, D7 added that this type of assessment more often regards the larger customers of the bank with a turnover ranging from 10-100 million SEK. Mentioned by B9 was also the level of dependency on suppliers as a part of the overall risk assessment of the company.

Sensitivity

Further, the authors found half of the participants to discuss how sensitive the firm is to different cyclical changes. Among them A1 explained the importance of being able to sell your products and services. Taking the real estate as an example, the participant pointed out that if you are to be granted a loan as to invest in real estate, the bank will want to be sure that you will actually be able to sell the apartments at a profitable price level. As cited by A1 “If it takes two years to sell the apartment, what happens then? Who will account for those additional costs of having an unsold empty apartment?” However, as described by A2, sensitivity analysis may also be conducted in terms of key ratios and how the turnover of the company will be affected by different impacts. This was also discussed by C6 who said that the interest rate sensitivity is something that the bank takes into consideration as to assess how large fluctuations the firm will be able to handle without defaulting payments. Also, the participant explained that there is always the possibility of conducting different types of scenario and sensitivity analyses as to assess the firm. This was agreed upon by D9, who also said that seasonal cyclicality might come to play an important role to the business of some firms.

Finances of the Customer and Collateral

During the interviews several participants expressed the importance of the owner’s own private economy. As some of the participant mentioned, the owners must be able to make a contribution of their own. A3 stated that a rule of thumb is that the customer should make a down payment of 20% and thus the bank can account for the other 80%. The same discussion occurred with participant C6 whom explained that it is important that the owner him-/herself believes in the firm, and stated, “If they do not want to commit, it is difficult for the bank to make a contribution”. Further, C6 emphasised that if the customer wants to borrow 100% it will be difficult, especially concerning start-ups with no result as they are seen to be riskier. Then the bank requires that the owner of the firm contribute with a decent amount him-/herself. The same reasoning was also raised by participant A2 and A4.

In regards to the owner’s private finances another topic that came to light were the willingness of the customer to add more money into the business if needed. Half of the respondents mentioned that this was a criterion in the credit risk assessment process, and A1 explained that the best possible scenario for the bank is if the owner is strong and has the ability to insert more money into the business if needed. Both B5 and E10 mentioned that they assess if the owner has the ability to support the company if it is not generating enough cash. Further emphasised by participant B5 was that, the willingness of contributing more money is a measure of commitment and shows that the owner has faith in his/her own business. As C6 stated, if the owner does not believe in the business, how could then the bank believe in the business. Continuing, C6 discussed the fact that it is important for the bank to know what alternatives that are available in case of a shortage of cash, is the bank going to be the one taking the hit or do the owner have any possibility of raising external capital. An equivalent reasoning was brought up in the interview with participant D9.
A2 explained that for a bank, collateral is always an important element, the participant also stated, “Without any collateral the bank takes a greater risk if something goes wrong”. Mentioned by both A2 and C6 was that as the banks do not possess venture capital, collateral is an important feature in the credit risk evaluation process, also as it is vital for the bank to not risk any unnecessary losses. The same reasoning was supported by A3. Further, participant D9 discussed different types of collateral, as there are different types of industries, and one example that was brought up were different consultancy firms, which has flourished during the last years. Continuing, D9 argued that a consultancy firm do not possess many tangible assets, thus a floating charge might not be possible to provide, and therefore as the bank almost always requires some kind of collateral leading to that the owner needs to provide a personal guarantee. A4 stated, “In general the bank works in order to minimize risks as we are not supposed to take risks. When we lend money, we must somehow ensure the credit and that we have sufficient collateral so if it would go wrong we would get our money back”. However, the same participant concluded that obtaining collateral can be difficult at many times, as a result the owner’s finances becomes important as it might become necessary for the owner to provide personal guarantees. B5 emphasised the same arguments as A4 during the interview, and explained that the personal finances of the owner becomes important, as an ownership bail might be needed. Further B5 deliberated that in the bank’s credit risk evaluation, valuing the collateral and assessing the security risk is an important feature.

Financial Statements and Financial Competence

When discussing the criteria used in the credit risk evaluation of SMEs, almost all the conversation tended to encompass financial statements and key ratios. A2, A3 and D7 explained that something the bank always looks upon in their credit assessment is the latest financial statements of the firm. A4 led a similar discussion and stated, “Everything comes down to different types of key ratios and cash flow”, where ratios as solvency and interest coverage were mentioned. The authors of the thesis found solvency to be a common factor included in the credit risk evaluation as all the participants except A2 mentioned it. Cited by D7 “There are many key figures, but solvency is everything”. Continuing, the participant said that it is difficult to state any guideline level, as it is highly dependent on the industry. Solvency was seen as a “Classic figure” by participant A3 and D7, of whom the latter also said that it is necessary to show upon these essential figures as to prove that the firm is healthy and well-functioning.

Except from solvency a wide range of different key ratios and figures were discussed with the authors of the thesis, where B5 determined that EBITA and ROCE are common measures that the bank assesses. Participant C6 had a different view of important key figures and ratios and mentioned debt-equity ratio, interest coverage and turnover. D7 were on the same track and mentioned interest coverage as a key ratio, while D8 mentioned turnover as an important figure and D9 debt-equity. The view of which figures and ratios that are important in the evaluation were not equally among the participants thus in order to get a better grasp, all the different key ratios and figures that were mentioned during the interviews and the occurrence of them are presented in figure 5.2.
D9 said that profitability was something that was also important to consider in the long run, that is if the bank believe that the company will continue to be profitable in the future. Further D7 elaborated that while it is not necessarily a crucial factor the bank still wants to see that the firm has sustainable profitability in the long run. This was agreed upon by A4 and D8. Continuing, A2 added that the profitability has a high influence on the price level set by the bank.

Participant D7 explained that except from the statements the participant prefers if the customer also can provide liquidity- and cash flow reports. A majority of the participants agreed with D7 and said that the cash flow statement was seen as something important, that the business owner should bring to a first meeting with the corporate advisor. A2 specifically said, "The cash flow statement and cash flow analysis are probably the most important aspects as to show the bank whether the firm will generate enough cash in order to pay back the credit". Further the participant pointed out to the authors of the study that it is something that is included within the framework set up by the bank and that the corporate advisor is obligated to evaluate. The importance of a cash flow analysis was also mentioned by A3, who however said that for a smaller firm, this type of analysis usually is not done. Importantly, as pointed out by B5 and C6 the cash flow analysis must also be conducted as to assess the long-term repayment capacity of the firm. This is in contrast to the answer provided by participant D8, who suggested that you might consider cash flows when granting a credit with shorter maturity.

Not surprisingly, the ability to repay a loan sometimes discussed in terms of liquidity was brought up by all except one participant. A1 described to the authors that the bank has a specific model where as to incorporate certain factors and from there get an analysis of the cash flows as to explore the repayment capacity. During the interview, participant E10 discussed cash liquidity as an important measurement of the short-term repayment capacity as to ensure the firm has sufficient liquid assets available, and solvency as a measure of the long-term repayment capacity. Further, participant B5 explained to the authors of the thesis that the
A4 explained to the authors that ratios are compared from year to year in order to assess the development, where C6 said that single ratios is not the most vital in the evaluation, as rather the important thing is to ensure that the numbers develops in a satisfying way. Further, argued by E10 was that ratios are used in order to assess current trends, but, the participant also explained that historical accounts commonly are used in the credit risk assessment process as it can give the advisor a hunch of the financial situation of the firm. This argument was agreed upon by many of the participants, where A2, A3, B5 and D8 expressed similar arguments. D9 elaborated for the authors that historical accounts do not lie, if the owner is super positive whereas the figures do not look very good it makes the bank to question the owner’s business acumen. The same participant stated, “Historical accounts are important, if the firm has performed badly the owner must be able to present good reasons for how the business will be turned around”.

When discussing financial statements and different figures and ratios with the participants the authors of the thesis raised the question regarding start-ups without any history and how the participants evaluate these kinds of firms. Nine of the ten participants mentioned that a budget is commonly used instead of the financial statements in the credit risk assessment however, as D9 explained, the bank also requires budgets from existing firms, as they want to see what the owner thinks about the future. This argument was supported by all of the participants except A1. Continuing, A4 stated “We want to have a budget from the firm, however often budgets are based on a lot of guesses, which makes them harder to evaluate”.

Control Measures

A3 explained to the authors of the study that in the credit memo, the advisor provides an analysis regarding what he/she thinks that bank may risk losing if the firm would default. Continuing, A2 said “The LGD-value is essential as to be able to determine a price, therefore you cannot set a price only by adding the loan to value ratio to the STIBOR rate”. Therefore the bank also has a section in the credit memo dedicated to a valuation of the collateral in case of default, we take into consideration an assessment of what the bank may lose and how big of risk is it that the firm will default. This was supported by A1 and D9 who mentioned similar arguments, and also discussed the internal rating system as a measure of the probability that the firm would default.
5.2.3 The Process

As the aim of the thesis is to determine criteria used by banks in their assessment of credit risk, the authors of the thesis also found it important to discuss how the credit evaluation process is structured in order to get a more profound understanding of the use of criteria. From the interviews, the importance of being versed in all the various sectors became evident. It was also explained to the authors of the thesis that all banks have access to different internal specialists that can provide them with industry analyses and facts if needed in their credit risk evaluation. Established by A3 “You cannot be versed in every sector, you need to listen to your clients and learn from them, they are the ones that hold the best knowledge regarding the specific industry”. This statement was supported by all the participants whom told the authors that the customer can provide the advisor with a lot of valuable knowledge. Further, C6 explained that the corporate advisors at the bank often have some kind of special expertise regarding an industry and thus to a large extent they can obtain the knowledge needed at the local office, the same thing was mentioned by all of the interviewees except from B5 and D8.

All of the participants stated that when meeting a client for the first time the mission is to gather as much information as possible, hence the meeting often results in that the customer is the one doing most of the talking. A3 stated, “Many customers are unprepared, it is a very abstract process and many customers have no idea of how the credit assessment process works”. Mentioned by the participants from Bank A was that they prefer if the customer provides them with a business plan, budgets and outlooks of the future, where similar statements were made by the other participants of the study. D7 explained that all material needed often is not obtained at once and thus the customer sometimes needs to complement the information afterwards. Both A1 and D7 explained to the authors of the thesis that they feel that it is difficult to meet with a customer for one hour and then determining their faith as the advisor’s decision can make a huge difference for the customer.

B5 stated that the evaluation starts with a meeting together with a credit analyst where they discuss the different parameters and analyse the firm before they reconnect to the customer. All banks stated that the evaluation process includes the establishing of a rating of the customer, and that they have their own internal rating methods for this. B5, D7, D9 and E10 specified that they use a direct translation of upplysningscentralen’s (UC) model in their classification. Bank A and C emphasised that they also use UC, but further explained that UC is more of a complement to their internal rating model. However, when the authors asked the participants what parameters that influence the classification model the answer they got was, as stated by D9, “I think it is very few individuals within the bank how really know what influences the classification model of the customer”.

As established by all of the participants except B5, the advisors need to conduct a summary of the customer and the firm in a memo. Bank A works according A2’s statement, “In the memo we need to describe the customer, which includes a cash flow analysis with the repayment capacity, a description of the business, what kind of collateral and also other factors that might affect the credit decision”. Comparable principles were emphasised by Bank C, D and E, as the participants explained that the advisor needs to establish a memo describing their main conclusion regarding the customer and the customer’s business in terms of both numerical and qualitative measures. It was concluded that all the banks have different policies and regulations that needs to be followed in order to ensure that all advisors works in a similar manner in the credit risk evaluation process. As A3 stated, “It is important that what the
advisor portray is the bank’s view, as a customer you cannot first ask mommy and get one answer and later ask daddy and get another answer”.

When discussing the credit granting decision the processes were seen to differ among the banks. The participants from Bank A explained that they have different levels of mandate in terms of granting credit but there must always be at least two people granting the credit. A2 emphasised “Having different mandates enable the bank to create more a local decision power closer to the customer”, the same reasoning was conducted by D7. Further, Bank A explained that the larger credits that are outside the advisors mandate goes to a central credit committee. Within Bank B, C and E the credit granting decisions are made in a central committee, and participant E10 explained that the memo is important as the committee base their decision on it. Further D7, D8 and D9 explained that almost half of the decisions are made at the local office where the manager is the one in granting the credits. The rest of the decisions that cannot be granted at the local office are sent to a central committee. D7 stated that the advisors do not make any decisions as to ensure that a single advisor cannot make own judgements and irresponsible decisions that might hurt the bank, also as then no one will be solely responsible.

5.2.4 Overall Assessment

Looking at the size of the firm and the company form was seen as important by several of the participants, and many expressed how these factors came to affect their assessment of the company and its risk level. In the interview with A2, the participant explained that a credit risk assessment of a smaller firm will only be based on the available financial figures and key ratios following an automatized model. However, A2 continues “Considering a larger company that is rapidly growing, then we need to make a more in-depth assessment as to understand what is really going on within that firm and who is running it”. Therefore, the qualitative criteria become more important when evaluating credit risk in a larger firm the participant added.

Participant D7 reasoned that when a smaller firm approaches the bank seeking a loan, the evaluation process is more reliant on key ratios derived from UC, which is a Swedish credit reporting agency. Therefore, the participant added, for a smaller company the key ratios are decisive. Continuing, D7 explained that for a larger firm the bank conduct an internal credit rating in combination with arguments provided by the corporate advisor regarding the more qualitative factors of the firm and the owner. Therefore, the participant has more influence in the credit decision for larger companies as medium-sized companies are to a greater extent evaluated upon qualitative criteria.

In contrast, E10 said that the smaller the company is the more emphasis is put on the individual that runs the company. As explained to the authors of the study at hand by A3, if the firm is a sole proprietorship, the private finances of the owner become more important as she/he is financially interlinked with the firm. When discussing credit risk evaluation in terms of firm size A3 said that the larger the company is the more formal becomes the process of granting credit.

Throughout the interviews, many of the participants expressed their belief that it is highly important that the bank actually understand and believe in the business and the overall business plan presented by the owner. Among them B5 and C6 explained to the authors of the thesis at hand that the bank always considers the firm, the owners and the underlying business
idea as it is crucial that it is a business that the bank believes in and understands. Specifically, C6 said, “If we do not understand the business, then we rather decline the deal”. To assess the business plan of the firm when taking a credit decision was also mentioned as an essential part of the process by all participants from Bank A as well as by participant E10. However, as said by B5, it is also necessary to understand the business plan as for the bank to evaluate whether this is something that will be profitable to lend money to, and if it is a business that the bank wants to engage with. Continuing on a similar trail, B8 argued that the business idea becomes more important if the firm is new having little or no historical records to analyse. The participant further added that when seeking a loan at the bank it is important for the customer to present a coherent and understandable business plan as to inform the corporate advisor about the different aspect of the firm and what kind of business it is engaged with.

Pointed out by C6, the credit risk evaluation process is an overall assessment of the firm. The bank want to see strong and stable long-term results as to ensure sufficient cash-flows in the future, and to develop sound relationships with healthy companies. However, as mentioned by A2 and D8, the historical record of the owner and the company is also something that is important for the bank to consider. The credit risk evaluation process might become easier if the firm has a historical record within the bank, as B5 explained. However, the participant also stressed that it is not a crucial factor, but merely something that might contribute to the decision. When the authors ask participant D8 whether there are any criteria that are more important as to evaluate credit risk the participant responded that “I cannot answer that, it is rather complicated as it is more of a mix or a balance as you want to see the overall picture of the firm”. The reasoning was also found to be supported by D7 who mentioned that you need a composition of different factors as to get an accurate view of the firm and its owner. As also mentioned by A1, “Adequate numbers and other quantitative factors is necessary for us to initially start the credit evaluation process, however the qualitative factors will ultimately be decisive as to whether we will grant a loan or not”.

Only few of the participants raised the question regarding environmental activities and ethical business as a factor included in the evaluation process. Among them, A4 said “Since we have an environmental policy within the bank, an environmental analysis will be conducted as it is important to make sure that the firm does not engage in any business negatively affecting the environment”. Continuing A1 explained that while the environmental aspect not directly affects the risk classification, it is still a factor that will have implication on the credit decision. C6 argued “We do not grant credit to firms that do not live up to the norms and standards set up by the bank, and we have cancelled credits to companies engaging in business that we do not sympathize with”.

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6. ANALYSIS

The analysis will be presented in accordance with the structuring of the empirical chapter, starting with a discussion regarding the clientele of the participants of the study. Thereafter, the authors of the study will assess the empirical findings in regards to existing theories as to be able to build new tentative theories in relation to the research topic. Lastly, a coherent summary of the analysis concludes the chapter.

6.1 Clientele

Quantified Measures

A majority of the participants expressed the size of the corporate customers in terms of turnover, ranging from 1 million and everything up to 500 million SEK. In line with the definitions made by the European Commission (2015a) regarding SMEs presented in section 3.3.1, the authors of the study can draw the conclusion that it is evident that all participants worked with a clientele falling within this segment of SMEs. Even though the definition is stated in Euro it is still evident that the corporate customers of the participants fall within the segment after adjusting for the exchange rate. Continuing, the European Commission (2015a) defines SMEs to include firms with a maximum of 250 employees. Thus an equal conclusion can be drawn regarding the participant that defined the clientele in terms of number of employees. Regarding the participants that solely stated that their customers belong to the segment of SMEs, the authors of the thesis are still bound to believe the accurateness of the responses given due to the professional experience of these individuals. Having established that the corporate advisors taking part of the study is working with a relevant clientele falling within the target segment decided upon by the authors of the study is of utmost importance as to ensure accurateness and validity of the analytic discussion and tentative theories built.

Industry Specifics

When discussing the clientele of each participant it became evident to the authors of the study that there were certain significant differences among these corporate advisors in terms of the industries in which their customers operate. Explained by B5, the bank find it important as to consider the overall risk profile of an industry, as to assess whether it is a sector that the bank want to include in its portfolio of outstanding credits. This became especially clear as each and every one of the participants expressed negative feelings against the restaurant sector, suggesting that it was commonly perceived as risky. D8 also especially emphasize that the bank found it important to understand the industry in which the firm operates when evaluating credit risk.

The authors of the thesis found evidence of the importance of macro-economic factors related specific industries to have certain implications on the credit risk assessment. Specifically, participant D7 mentioned the importance of considering the level of regulation and governmental aid within an industry sector when evaluating credit risk. Considering the empirical research presented by Beck et al., (2005, p. 162) smaller firms tend to be increasingly sensitive in terms of growth opportunities to factors such as the level of stability within the economic legal and political environment surrounding the firm. Hence, evidence proving the finding presented by the authors of the thesis was established in existing theory.
However, as earlier discussed, Beck et al. (2005, p. 140) have based their study on an alternative definition of SMEs than what is presented by the European Commission. Therefore, the authors of the thesis at hand find the empirical results to be of utmost importance at to generate further theory regarding the segment of SMEs.

Discussed by Altman & Saunders (1998, p. 1723) whom suggested that financial institutions commonly compare various key ratios among firms within the same industry to evaluate the borrower. However, within the empirical chapter, the authors of the thesis could also establish that banks do not only compare ratios among firms within the industry, but rather with an industry average as to evaluate current and future profitability. However, while having established a clear connection between industry and variances in the credit risk evaluation process, the authors of the thesis at hand do not build further upon these findings, as the aim of the thesis is to initiate an exploration of the topic rather than seeking detailed explanations.

6.2 Criteria

Individual

The corporate advisors had very scattered views of how the individual really is evaluated. Several of the participants argued that an individual cannot be evaluated by specific features and rather that it is the gut feeling that the advisor gets from talking the owner that will be assessed. This is in line with the findings of Jankowicz & Hisrich (1987, p. 85) whom concluded in their research that the borrowing decision is not only based on quantitative information, where the authors were clear to state that the qualitative part of the assessment of credit risk is highly subjective.

In contrast Bruns & Fletcher (2008, pp. 184-185) emphasised that when evaluating the individual in the credit granting decision characteristics as the owner’s previous expertise and competence are factors that are considered. Continuing, the authors stated that these characteristics of the owner even could increase the chance of receiving credit. As established in the empirical findings, A1 stated that sometimes a particular owner’s expertise and experience can be so important that the bank require the individual to sign an agreement that they will stay within the business, if the individual leaves the firm the credit granted will be withdrawn. Hence, the authors of the thesis are made to believe that the owner majorly affects the credit risk evaluation decision, as banks even are willing to make separate deals in order to secure a particular individual in the firm and as previous research shows that the individual characteristics even can increase the chance of being granted a loan.

Continuing, some of the participants pinpointed different characteristics that they viewed as important in the credit granting assessment, where drive, risk profile, personality, experience and knowledge were most commonly mentioned. In a study of Bruns (2004, p. 22) the author found differences in past research regarding how credit risk should be evaluated when granting credit, where some scholars argue that borrower characteristics is most important. However, the participants were clear to state that an owner will not be denied a loan due to that the person lacks a specific characteristic, rather it comes down to the general impression of the individual but specific characteristics can be helpful.

As all participants as well as previous research show different views and approaches to the evaluation of the individual it is difficult to the authors of the thesis to assess if the evaluation should be made on specific features or if following the gut feeling is a more valid method.
However, what can be determined is that the owner will play an important part to whether the firm will be granted credit or not. As stated by B5 “First and foremost when assessing credit risk, what we evaluate is the owner, is this a person that we believe in?” A3 expounded the same point of view and emphasised that over time it has become apparent that the evaluation is highly dependent on the owner of the firm and also stated that as long as the individual provide the advisor with a good gut feeling, the bank will always find a solution for the owner to obtain credit.

**Key Individuals**

In addition to the owner, the authors of the thesis found evidence suggesting that banks do take into consideration other key individuals within the firm as to make a credit risk assessment. As said by participant C6 “The individuals running the company are very important to the success or failure of the firm”. There are however little existing empirical research conducted regarding the key individuals of the firm and how they might affect the credit risk evaluation. Hence, the empirical findings presented within the thesis at hand contribute with new certain new insight as to what criteria banks consider when evaluation credit risk.

Established by Eisdorfer et al. (2013, p. 550) within their empirical work is that the manager will make investment decisions highly influenced by his own personal incentives and consequently, sometimes not in accordance to the best alternatives for the firm. This was also found to be evident within the empirical findings of the thesis at hand as one participant suggested that a firm might have the potential to be very profitable, but if the owner does not hold the right knowledge and expertise, the firm might risk default. Further, A3 stated, “Still, it comes down to the people within the company that I work with, these are the ones who in the end will make a difference”. The participant also explained that maintaining experienced and talented individuals during within the firm an acquisition may actually be decisive to aw whether the bank will grant a loan.

**Relationship**

It was found that Bank C commonly is interested in holding a clientele within the local area, as the bank then believes that it can get to know the customer better. The aim of the bank is to create long-term relationships resulting in creating facilitating conditions, as to make sounder credit risk assessment decisions. Stressed by Dahiya et al. (2003, p. 375) is that it is beneficial for both the borrower and the bank to have an established relationship. The borrower is often rewarded with a lower interest rate on the loan, whereas the bank is able to receive valuable information from the borrower (Dahiya et al., 2003, p. 376). In regards to the thesis at hand, the authors of the thesis argue that the relationship with the lender seems to be an important criterion for evaluating credit risk of SMEs, as it is indicated, through the relationship the banks can obtain more valuable information which in term facilitates the credit granting decision. This finding is in line with the previous findings of Dahiya et al., (2003, p. 375) whom conclude that keeping long-term relationship with customers is in the interest of banks.

In the empirical section it was found that existing customers have an advantage against new customers in the credit risk evaluation process, as A4 stated “However, we would rather help an existing customer if there is something negative within the firm than an owner that we don’t know”. Cenni et al. (2015, p. 250) suggest that the relationship formed between SMEs and financial institutions are important, as SMEs often have limited access to external
financing and thus are more influenced by the bank’s credit decision. Further discovered is that both SMEs and large firms benefit from forming relationships with a limited amount of credit-granters which implies that forming few but strong relationships may decrease the possibility of facing credit rationing (Cenni et al., 2015, p. 260). From the empirical findings it was concluded that in the case of two equivalent customers, one of which is an existing customer and the other one is not, reasonably, it will be easier for the existing customer to be granted credit, explained D7. The reasoning was supported by A1, B5 and D9, whom concluded that for an existing customer the evaluation might be slightly more at ease, compared to a new customer. This is in line with previous research by Cole (1998, p. 959) who emphasise that if the borrower has an established relationship with the bank, the borrower is more likely to be granted a loan. Further, the author explains that the length of the relationship stands irrelevant. Although, this contradicts the findings that the authors of the thesis made, where some of the participants stated that a relationship between the bank and the borrower facilitates the credit evaluation as the banks then have a history to assess from the borrower. Thus, the relationship needs to be at least as long such that relevant historical measures can be used.

Determined by A2, the relationship between the bank and the customer will be damaged if the firm is unsuccessful for a longer period of time, and often the soundest thing to do is to end the relationship, as it is hard to restore again. In the research of Dahiya et al. (2003, p. 376) equal implications are made, where the authors explain that if a borrower suffers of financial distress it will most likely harm the relationship between the borrower and the bank. Thus, it makes the authors of the thesis to believe that it is not only positive to have an established relationship with a financial institution as in the case described above, the borrower is not likely to be granted credit again due to the harmed relationship between him/her and the bank.

The authors of the thesis can establish that both empirical and theoretical findings stress the importance of the relationship between the borrower and the bank and that it is something that largely affects the credit granting decision. However, the knowledge formed from the theoretical chapter do not conclude that the relationship something that banks evaluate rather that it is important and seen as something that can be helpful for the borrower. Not as the empirical findings implies, something assessed by the banks when granting credit.

External and Internal Discipline

During the discussions, it also became evident that the participants found the external and internal discipline of the firm to be important factors taken into account within the credit granting decision. As expressed by the participant A4 “We really consider the internal discipline because if that is inadequate, that is kind of the first thing, the firm must really have been managed well and that the owner has not previously misbehaved towards the bank as for us to be willing to lend out money”. Continuing, another participant told the authors of the thesis that it is not in particular the defaulted payment that will determine whether you will be granted a loan, but rather the behaviour and the attitude of the owner. As pointed out in earlier chapters, there is a significant gap within empirical literature regarding such qualitative measures of credit risk. Hence in regards to the purpose of the thesis, the authors believe that this finding will prove valuable as to expand the knowledge regarding credit risk evaluation.

Another aspect that came to be discussed was the importance of the personal finances of the owner, and the way he/she have managed financial obligations in the past. Several participants explained that if the firm is a sole proprietorship, the owner becomes interconnected
with the firm, both financially and judicial and consequently it is necessarily to assess also the private finances of the owner when evaluating the credit risk of the firm. The authors of the study at hand found no empirical evidence regarding the importance of incorporating such considerations within the credit risk assessment and hence these findings are believed to contribute certain knowledge to the field. As a result, the authors suggest that in terms of smaller firms, with no legal separation of the entity and the owner, the ability of managing personal finances ought to be incorporated within the risk evaluation.

As explained by Harris & Raviv, (1991, p. 306) the capital structure of a firm may give outside stakeholders certain clues regarding inside information held by managers. However, considering the purpose of the thesis at hand being to explore the credit risk evaluation of SMEs, the clientele of the participants was ensured to be constituted by firms within this segment and thus little signalling of information is provided. Evident from the empirical findings presented within the thesis at hand is thus the issue of transparency among these smaller firms, as the lack of publicly available data enforces certain restrictions to the credit risk evaluation. Several participants expressed their belief that it will always benefit the firm and its owner to be honest about the business, even in times of financial stress. As stated by A2 during the interview, “If the customer had not been transparent and open towards us, we would definitely not have been interested in lending out any more money to that firm as to get business going again”. Consequently, it became evident to the authors of the study that the issue of transparency as discussed in previous empirical literature is something that is significant to banks throughout the credit risk evaluation process.

While current empirical literature tends to focus on quantitative measurements as to produce models for credit risk evaluation, little emphasis is devoted to the credibility of the figures and ratios included within such models. Hence, the authors of the thesis at hand find one important finding originating from the discussions with A1 and D7 is the fact that no business will follow an entirely straight path of constant growth. Rather than trying to present perfect numbers and a promising budget, being credible in terms of your business and what information presented to the bank will have a more positive influence on the risk evaluation.

Contracts with Customers and Suppliers

Established within the empirical findings, was the importance of stability and diversification in terms of contracts with customers and suppliers held by the firm seeking credit. As explained by D7, the bank will assess the underlying risk originating from such contracts and how dependent the firm is on its stakeholders. Continuing as pointed out by one participant, it is necessary to not only assess the current contracts, but also the firm’s ability to establish new relationships with outside stakeholders. The authors found limited empirical research discussing the importance of contract in terms of credit risk, hence the findings of the thesis at hand is believed to be of high importance as to contribute with further knowledge regarding the different criteria assessed by banks as to determine credit risk among SMEs.

Bruni et al. (2014, p. 766) mention that credit risk however does not solely regard the parties directly involved within a lending decision, but also the financial stability of the customers of the firm seeking credit. This was also proven as participant A1 explained to the authors of the thesis “If you consider a larger industrial firm, their customers will be large manufacturing companies and then we of course need to know how these contracts are formed and how does the customer’s market look like? At what point in their business cycle do they operate? Does the company have international customers? That is some factors that we consider when
making an evaluation”. Hence, while a vast amount of customers is valuable, the bank will ultimately evaluate the quality of these customers, at it is through them that the firm will generate earnings used to pay amortizations and interests to the bank. Consequently as explained by B8, if the firm is able to provide evidence of several long-term contracts with strong and profitable customers the bank will be more willing to grant the firm a loan.

Discussing property loans participant D7 elaborated to the authors of the study that “Then you want to see that the firm will have sufficient cash flows, maybe not for the whole duration of the loan, but take the coming 5 years, what contracts do they have? Will they generate income as to cover their interest payments and amortizations?” As explained by Titman & Wessels (1988, p. 14) within their empirical work, smaller firms tend to take on less long-term debt due to the increased transaction costs incorporated with such obligations. However, evident to the authors of the thesis was that when SMEs do seek loans with longer maturity, stable contracts with customers and suppliers is an essential part of the credit risk evaluation.

Many of the participants mentioned the firm and its relationship with suppliers as a key component within the overall credit risk assessment. Explained by B9 a firm that is highly dependent on one or a few suppliers will inevitably be affected if these suppliers would default or end their contracts with the firm. The empirical findings presented within the thesis was found to be in line with the arguments of Bruni et al., (2014, p. 766) whom also suggested that dependence on very few suppliers may increase the endogenous credit risk of the firm.

Sensitivity

In the empirical findings it was discovered that an important criterion that banks evaluate is if the firm can survive different cyclical changes. The participants explained different scenarios such as if the interest rate increases, would the firm still be able to pay its obligations or due to cyclical changes is the firm still able to sell its products and services. In the theoretical frame of reference Flood & Korenko (2015, p. 43) states that one way to test credit risk is through stress testing and scenario analysis in order to understand the bank’s risk exposures. Hu et al. (2014, pp. 81-82) mention that stress testing mainly is used to measure the banks’ vulnerabilities to external factors, for example an event such as the latest financial crisis could have been assessed in a stress test how the bank would of coped. It is evident that analysing sensitivity is something that is used by the advisors in their credit risk assessment. However, in regards to the theoretical and empirical findings the authors of the thesis believe there is a gap to be seen. As the theories mainly discuss stress testing and scenario analysis in relation to the riskiness of the banks, not in regards of the borrowing firms as stressed by the advisors participating in the study.

Finances of the Customer and Collateral

In light of the empirical findings several of the participants concluded that the owner’s private finances are something that affects the lending decision. It was established that the ability of the owner to make a down payment is important, as the banks are not willing to finance the entire amount. Continuing, collateral was also something that was found to be important and the participants were clear to state that as banks do not possess venture capital banks are not allowed to risk money. A similar conclusion is established in the theoretical frame of reference by Miller & Murphy Smith (2002, p. 69) where the authors state that if the bank
does not feel secure about the safety provided, the amount being granted will most likely be reduced to a level where the bank feel comfortable.

Something that also was established to be evaluated is the owner’s willingness to contribute with more money into the business if needed. As stated by C6 “If the owner does not believe in the business, how could then the bank believe in the business”. Thus, the authors of the thesis were made to believe that this indirectly reflects the owner’s beliefs in the company, which is taken into consideration into the evaluation. This is something that authors of the thesis could not find any previous theoretical evidence of supporting that banks assess the willingness of the owner in their credit risk evaluation. Thus, the authors are made to believe that new empirical knowledge has been established.

Financial Statements and Financial Competence

In the empirical findings it was evident that the participants incorporate several numerical measures based on the latest financial statements in their assessment of firms. Solvency was mentioned by participants except one, as a “classic figure”. Other quantifiable measures that were mentioned by the participants were profitability, cash flow analysis and the repayment ability. Further the empirical findings show that the advisors use a variety of ratios in their evaluation of credit risk and which ratios that were used was highly individual.

As stated in the problem background, quantifiable measures, as different numerical ratios and figures are the most commonly known way of evaluating credit risk (Sigblad & Wilov, 2008, p. 181). It is evident that the empirical findings made by the authors of the thesis are in line with the theoretical findings. However, due to the scattered view of different ratios found used by the advisors it is hard for the authors of the to establish any practical knowledge of how the banks evaluate credit risk, as there even are differences within the same banks in terms of which ratios that are used in the assessment. Of course this fact can depend on that the advisors work with clientele within in different industries and thus different ratios are required. Although, the participants never explained these ratios in a specific context as rather the ratios mentioned generally are assessed in the commonly credit evaluation process.

As previously mentioned the most commonly used measures when evaluating credit risk are key ratios and figures, however these measures are profoundly based on historical financial statements. In cases where the firm cannot provide historical accounts it was found that the advisors assess a budget provided by the firm. Though, the participants were clear to state that they also prefer to obtain a budget from firms with financial statements as well, as the budget will give the advisors a hint of how the owner looks upon the future of the firm. In the theoretical frame of reference it is concluded that evaluating a start-up firms is difficult as they lack the ability to be assessed on previous accomplishments (Miller & Murphy Smith, 2002, p. 69). Established by Bruns & Fletcher (2008, pp. 184) is that one major factor affecting the credit granting decision is the firm’s past performance, which creates a problem for newly started firms, as they cannot provide any past performance. In accordance to the thesis at hand, the empirical findings are in line with the previous already established literature, that banks commonly assess historical accounts in their evaluation process and it creates problems in terms of start-ups. However, the authors of the thesis had trouble finding any literature supporting the empirical findings of assessing start-up firms through budgets as theory mainly focused on the historical accounts. The authors feel safe to establish that a budget is something that advisors assess in their credit risk evaluation as nine out of ten participants mentioned it.
Further the participants discussed different approaches to key figures and ratios where it became evident that as long as the numbers develops in a satisfying way a single ratio will not affect the credit granting decision. Citing E10, “Historical accounts are important, if the firm has performed badly the owner must be able to present good reasons for how the business will be turned around”. Further, E10 explained that historical accounts commonly are used in the credit risk evaluation process, as it will give the advisor a hunch of the financial situation of the firm. An interesting finding was made as D7 explained that key ratios are more common to be used when evaluating new clienteles compared to existing. This is a bit contradictory to the theoretical conclusions, as the participant said that it is difficult to assess new firms due to the lack of financial statements. Instead predictions have to be based on their budget and hence the validity of the predictions can be difficult to evaluate.

Summarizing, it is clear to state that the empirical findings regarding financial statements and key ratios highly support existing literature. As mentioned in the problem background most literature assesses quantifiable measures of credit risk and the area is already extensively examined. Though as the authors of the thesis aim to provide a list of criteria used by banks in their credit risk evaluation of SMEs the finding still provides great insight.

**Control Measures**

As established within the theoretical chapter, there has been little effort as to regulate the monitoring of smaller firms and hence, the authors of the thesis found it important as to assess the control measures employed by Swedish banks when evaluating the credit risk of SMEs. Established within the empirical findings was however that merely half of the participants discussed different types of measures as to control default risk. When discussing control measures, PD and LGD were the means of assessing credit risk mentioned by the participants which also supports the reasoning of Dietsch & Petey, (2002, p. 303).

**Capital Structure**

Within the theoretical framework, the capital structure of the firm was found to be an essential part as to understand the financing behaviour and investments decisions of SMEs. While capital structure was never mentioned directly by any of the participants as to be something that they consider within the credit risk evaluation process, the authors of the thesis found certain evidence as to how the capital structure of the firms seeking a credit indirectly comes to affect the credit granting decision. Thus, the authors of the thesis are bound to believe that the capital structure still is important to further discuss as it accounts for such a large part of the financing decisions of SMEs.

Brealey et al. (2011, p. 486) explain that firms with a large amount of taxable income and tangible assets will generally benefit from a higher leverage ratio and that firms holding similar asset structures should have an incentive to strive towards the same debt ratios. As firms within the same industry provide similar products and/or services, these firms naturally come to hold similar assets structures as well. Consequently, the trade-off theory was found to be helpful as to aid the authors of the thesis to explain how the incentive to take on debt might differ among industries. This became especially evident as real estate companies was described in terms of specific characteristics, such as the amount of tangible assets, that affected the way credit risk is evaluated.

Continuing, as discussed by Eisdorfer et al., (2013, p. 550) an agency problem might arise if the personal incentives of the manager come to affect the investment decisions taken. That is,
if the manager acts as to maximize his/her own utility rather than the overall value of the firm
the observed capital structure might not be in accordance to the optimal debt level.
Established in the empirical findings presented within the thesis was that all participants
expressed the individual and/or owner behind the firm seeking a loan to be of utmost
importance when assessing the overall credit risk of that company. Specifically, participant
E10 argued that it is important to assess the risk profile of the owner before granting a credit,
this due to the fact that business owners tend to have various risk appetites as further
explained by A2. Hence, an owner with high risk appetite might be attracted towards taking
risky decisions as to maximize personal utility, while simultaneously exposing the firm to
increased default risk.

In terms of the agency theory, Damodaran (2011, p. 367) discuss the conflicts that may arise
between shareholders and bondholders due to these groups of stakeholders commonly have
varying incentives. Seen as the thesis at hand is focused on the credit risk evaluation of SMEs
and that firms falling within this segment seldom have much external equity outstanding or
issues bonds, the authors of the thesis do not find a discussion regarding shareholders and
bondholders to be applicable in this specific context. However, the authors of the study believe
that the agency theory could be transferred as to describe the relationship between the
SME owner and the bank issuing a loan. As earlier discussed, Damodaran (2011, p. 367)
explains that shareholders commonly strive towards maximizing the value of the firm and
subsequently their equity claim whereas bondholders tend to be more risk averse seeking to
ensure the repayment of their claims outstanding. Likewise, the owner of an SME might have
incentives as to maximize personal gains hence taking on excessive risk, which might not be
in line with the risk level preferred by the bank. This was seen as both A2 and C6 stated that
banks do not grant loans if the risks are perceived to be too high, and do not hold any venture
capital.

6.3 The process

The authors of the thesis believed that the credit granting process needed to be assessed, in
terms of creating a better understanding of the criteria used by banks in their credit risk
evaluation of SMEs. Concluded in the empirical chapter were that the advisor could not be
versed in all the different industries of their customer and most knowledge regarding the
different industries were obtained from the clientele. However, all of the banks had central
departments within the bank, which can provide the advisors with e.g. specific knowledge or
industry analyses if needed. The authors of the thesis have found no theoretical reference
establishing that advisors should be versed in order to make sound credit decision. However,
in regards to the empirical findings the authors can conclude that the advisors put a lot of
emphasis on the customer’s expertise and knowledge of the specific industry they operate in.

The credit granting process basically looks the same for all the banks, with small adjustments.
All the banks starts an errand by meeting the customer where the advisor gather all the
material needed for the evaluation, in terms of both assessing the individual but also receive a
budget and the owner’s own thoughts. However, as stated by D7 the advisor often needs to
complement the information received from the customers, as all customers not are aware of
what they are expected to provide. This is somewhat in line with the arguments of Bruns &
Fletcher (2008, p. 171) that emphasises if the firm understand the credit evaluation process
the chance of being granted a loan increases. Thus, if the firm can understand the criteria in
the process they can provide the advisors with adequate material at once and in term the
advisor do not have to assess valuable time to chase the customer in order to obtain all
relevant material. Supported by A3, “Many customers are unprepared, it is a very abstract process and many customers have no idea how the credit assessment process works”.

After the advisor have gathered all relevant material, all banks except Bank B, writes a memo where the advisor analyses the information and assess the different criteria after a predetermined template of the bank. In Bank B on the other hand, the corporate advisor meets with a credit analyst and discuss the client. Concluded in the empirical findings was that all banks have their own internal rating processes where they assess the riskiness of the customer. This is in line with the Basel II Accord, which opened up the possibility for banks to adopt their own internal rating systems for credit risk (Dietsch & Petey, 2002, p. 303). Treacy & Carey, (2000, p. 168) is one the same track as the authors state internal ratings has been initiated by large banks in order to approve, analyse, price and monetisation of loans.

There are also differences when the actual credit decision is to be made, in Bank A the decisions are made in duality, whereas Bank B, C and E have a credit committee who either grant or declines. In Bank D, the manager of the local office is the one making all the decisions however, in case of large credits outside the banks’ decision mandate, all banks have an equal process where a central committee make the credit decision. As established in the theoretical frame of reference, the lending process is conducted in a similar way in all banks in Sweden (Sveriges Riksbank, 2001, p. 66). Thus, the authors believe that the empirical findings are in line with earlier research, where it is concluded that the credit risk evaluation processes are quite similar between Swedish banks. Rather, what differ are the criteria used within the credit risk evaluation.

6.4 Overall Assessment

Discussed by the authors of the thesis within chapter one, there is a significant gap found in existing literature regarding the qualitative criteria used by banks in the credit risk evaluation process. Commonly, as pointed out by Chen et al., (2015, p. 127) empirical research has been dominated by statistical models with little emphasize on the qualitative factors of the firm, its owner and other key individuals. In contrast, Jankowicz & Hisrich (1987, p. 45) argued that the credit granting decision will depend both on qualitative and quantitative factors of the firm. Hence, as proven by Bruns (2004, p. 22) exiting theory tend to be rather contradicting as to what factors are the most important to the credit risk evaluation process.

Established within the theoretical framework was that the need for financing will alter throughout the life cycle of the firm (Berger & Udell, 1998, p. 614). However, the authors also pointed out that the lack of publicly available data of SMEs has come to add certain restrictions to empirical research as to understand the demand and supply of external sources of capital. Addressing the issue, participant A2 said “Considering a larger company that is rapidly growing, then we need to make a more in-depth assessment as to understand what is really going on within that firm and who is running it”. Consequently, as suggested by theory, the authors of the thesis are bound to believe that as the need for, and availability of different sources of financing will constantly alter throughout the life cycle of the firm, the overall assessment of the company will become more complex for a rapidly growing firm.

As mentioned by several participants, the size of the firm will inevitably affect the different measures and procedures employed as to evaluate the risk level of the firm. However, as proven within the empirical chapter, the participants describe different approaches as to how credit risk valuation varied with the size of the firm. Consequently, it is difficult for the
authors of the study to determine a specific procedure as of how different criteria are incorporated within the evaluation.

Frequently mentioned during the interviews was that it is of high importance that the corporate advisor and the bank actually understand the business of the firm and how it will generate profits. Two participants also specifically emphasized the importance of understanding the business plan of the firm as to assess whether it is something that the bank actually believes in and wants to be associated with. For the firm to provide the bank with a business plan was mentioned by B5 to be of even higher importance if the bank has no historical records of the firm to base the credit risk evaluation on.

After all, as established by the authors of the thesis within the empirical findings chapter, the credit risk evaluation process is an overall assessment of the firm. According to the empirical work of Sommerville & Taffler (1995, p. 284) banks tend to be heavily reliant on numerical models as to evaluate credit risk. However, the authors of the thesis found evidence suggesting that also several qualitative criteria are incorporated within the overall risk assessment of the firm. However it is clear that there is no specific method or set of criteria used by all banks, but rather each advisor incorporates a mix of what is required of the bank and what he/she believes is necessary in regards of that specific customer, as explained by D8 “I cannot answer that, it is rather complicated as it is more of a mix or a balance as you want to see the overall picture of the firm” when asked whether there are any criterion that is more important during the credit risk evaluation. Significant to financial institutions is the risk of defaulting payments among its customers hence the credit risk evaluation process employed by banks is gaining increasing importance as to mitigate losses (Bruni et al., 2014, p. 766). Thus, it was also evident to the authors of the thesis at hand that bank wants to establish strong and stable long-term relationships with sound profitable companies as to be able to minimize the credit risk and ensure that the loan will be repaid.

Lastly, while environmental factors and ethical considerations might not be considered as measureable criteria within credit risk evaluation, the authors of the thesis found these aspects to have certain implications to the possibility of being granted a loan. As pointed out by some of the participants, the bank might have a policy not to engage in business with companies that do not fulfil certain ethical and environmental requirements, and in that case the authors of the thesis argue that such factors may have an impact to whether the bank will even start a credit risk assessment or not.

6.5 S&P

The aim of thesis is to establish the criteria used by banks when evaluating credit risk of SMEs. The authors found it interesting to compare their findings to assess if there are any similarities with the evaluation criteria of one of the large rating agencies, namely S&P. Scalet & Kelly (2012, p. 478) state the entities usually being rated by the credit rating agencies are large global firms or even national governments. In light of this will the structure of the analysis in this section will differ from the other sections within this chapter. This is due to that the sub-question regarding the criteria used by S&P is of a more descriptive nature and as a result the analysis regarding similarities with criteria used by banks and S&P will first be described and then compared to each other.

In the banking industry ratings play an important role as financial institutions commonly adopt credit ratings in their credit risk assessment of larger firms (Bottazzi et al., 2014, p. 766).
However, Gunnarsdottir & Lindh (2011, p. 30) emphasize that in comparison with rating agencies, financial institutions may take other factors into consideration in their evaluation as e.g. the size of the firm and historical relationship with the bank. Hence, it is interesting to investigate if S&P’s rating models can be transferred to SMEs’ in Sweden and not only on to large global firms. In regards to the empirical findings it was evident as factors as size and historical relationship had affected the banks credit risk evaluation.

Similar to what was found regarding the banks’ own internal rating systems S&P uses a risk classification scale divided into investment grade and speculative grade with ratings ranging from AAA down to D (S&P, 2014, p. 10). Equal to the banks practices, a better rating/classification leads to lower costs e.g. in terms of interest or when issuing a bond. In the establishment of credit ratings, S&P usually assesses information provided from the issuer, where the first step is to determine the issuer’s creditworthiness (S&P, 2009, p. 12). Compared to the empirical findings made by the authors of the thesis the same criterion is used by the corporate advisor in their assessment of SMEs. Thus, the authors can determine that creditworthiness is something that both banks and S&P use in their credit risk assessment. Also evident is that S&P evaluates anticipated fluctuations in the business cycle that might affect the firm. This is in line with the findings made in the empirical data, where several advisors explained that they need to evaluate how the firm copes with cyclicality.

Continuing, other criteria that was found used by S&P in their assessment of credit ratings were, the legal structure, the repayment priority order in case of default and external support including, letters of credit, collateral, insurance, and guarantees. In contrast to the findings made during the interviews, there are some differences to been seen, and the authors of the thesis argue that this due to the different size of firms that S&P assesses and SMEs. As established, the criteria S&P evaluates are more complex and deeply covered, as they assess the legal structure, letters of credit and insurance, whereas the banks more generally only evaluate the collateral. The authors are made to believe that this is due to that large firms often have more complicated structures than small firms and thus S&P’s evaluation becomes more complex with more elements to incorporate.

Both historical and current available information is assessed by S&P in their evaluation (S&P, 2009, p. 4). S&P predominantly use two different evaluation techniques, the model driven and the analyst driven, where the analyst driven rating approach is the one used when assessing firms (S&P, 2009, p. 8). The analyst driven approach is conducted by an analyst in combination with a team of specialists assessing the creditworthiness of the firm, the information is a mixture of interviews with the issuer and financial statements. In the credit rating evaluation there are two main categories being the analyst assess, the business risk and financial risk (S&P, 2013). Compared with the empirical findings the authors conclude that both S&P and the Swedish banks participating in the study assess historical and current information in their credit risk evaluation.

Business risk features industry characteristics, company position and specific country risk, whereas financial risk incorporates an assessment of the capital structure of the firm, a cash flow and/or leverage analysis to assess a firm's financial risk profile and accounting variables. For the lower rated firms the financial risk profile becomes more important whereas for investment grade rated firms the business risk is more profound. Several other factors can impact the analyst decision before a rating is definitive these factors are diversification/portfolio effect, capital structure, management and governance, financial policy and liquidity (S&P, 2013). In light of the empirical finding, similarities are seen
between the criteria of assessing credit risk used by banks and S&P, as industry specific measures, cash flow analysis and accounting variables also were mentioned by the advisors. However, as the clientele of the advisors commonly were locally based, a country risk evaluation might not be as relevant for banks to assess as it is for S&P, whom rates firms from different countries. Further, nothing was mentioned during the interviews regarding assessing the capital structure of the borrower.

The criteria analysed within the business risk category profile typically are a mix of qualitative assessments and quantitative information. The qualitative assessment incorporates evaluating country specific risk as law risk, financial system risk, economic risk, institutional and governance effectiveness risk and a firm’s competitive advantages. Whereas, the quantitative information comprises historical cyclicity of profits and revenues, it may also embrace the level of profitability and volatility in terms of evaluating a firm’s competitive position. S&P also analyses the firm’s capacity to generate cash flows in order to assess if the firm can pay its obligations in time. These findings regarding criteria used by S&P are in line with the banks’ assessment, as established the banks commonly use a mix of qualitative and quantitative factors where the overall assessment is what matters in the credit granting decision. However, the criteria regarding law risk, financial system risk was not found to be used by the financial institutions.

In terms of defining the financial risk profile, S&P focuses on quantitative variables as to assess patterns of current, historical and future cash flows, relative to the company’s cash obligations, which is a good indicator of the financial risk of the firm. S&P states on their website that they generally use a variation of credit ratios in order to assess the credit risk of the firm and also that S&P use ratios that are most suitable for measuring industry specific characteristics. Where the predominantly criteria they assess is the repayment capacity of a firm and the cushion the firm possess, measuring the company’s ability to survive through stressed periods, commonly used to measure this is interest coverage ratios. Compared to the findings made by the authors of the thesis the determination of the financial risk profile by S&P is similar to criteria used by banks to assess credit risk of SMEs. The repayment capacity and cash flow were frequently mentioned by the participants also in line with the banks assessment are that S&P uses different ratios depending on the various industries. The general impression of the criteria used by S&P is that the quantitative criteria used is quite similar to the ones used by banks, however, they tend to make deeper analyses and thus incorporate more factors into the analysis.

6.6 Summary of Empirical Analysis

With the underlying purpose of the thesis in mind, the authors do not aim to explore further the different characteristics of various industries but to prove that the different industries in which firms operates will have an impact on the credit risk evaluation process employed by financial institutions. This was also evident as the empirical findings of the thesis suggest that Swedish banks do in fact adapt the criteria assessed after different industries.

However, apparent was the vast amount of different criteria considered throughout the credit risk evaluation process that were mentioned by the corporate advisors taking part of the study. The participants was encouraged to respond in a narrative way as the authors believed that it was important to capture the participants’ point of view as the authors of the study found the individual opinions of each participant to be valuable. As a result, the criteria found were reviled through the interviews, both directly stated by the participants but also embedded
within the discussions. Continuing, as to provide a coherent overview of the empirical findings, the authors of the study present the criteria discovered within Table 6.1 also showing upon the frequency of each specific factor. The criteria found have been sorted according to how the participants described these criteria to be quantitative or qualitative.

Table 6.1 Criteria Used in Credit Risk Assessment Discussed by the Participants

<table>
<thead>
<tr>
<th>Qualitative Criteria</th>
<th>Occurrence</th>
<th>Quantitative Criteria</th>
<th>Occurrence</th>
</tr>
</thead>
<tbody>
<tr>
<td>Business Plan</td>
<td>8</td>
<td>Budget</td>
<td>9</td>
</tr>
<tr>
<td>Company Form</td>
<td>5</td>
<td>Cash Flow</td>
<td>7</td>
</tr>
<tr>
<td>Contracts</td>
<td>6</td>
<td>Collateral</td>
<td>6</td>
</tr>
<tr>
<td>Credibility</td>
<td>3</td>
<td>Down Payment</td>
<td>4</td>
</tr>
<tr>
<td>Customer’s Customers</td>
<td>7</td>
<td>Financial Statements</td>
<td>9</td>
</tr>
<tr>
<td>Cyclical Sensitivity</td>
<td>3</td>
<td>Historical Accounts</td>
<td>7</td>
</tr>
<tr>
<td>Environmental Activities</td>
<td>2</td>
<td>Loss Given Default</td>
<td>3</td>
</tr>
<tr>
<td>Ethics</td>
<td>2</td>
<td>Probability of Default</td>
<td>2</td>
</tr>
<tr>
<td>External Discipline</td>
<td>8</td>
<td>Profitability</td>
<td>5</td>
</tr>
<tr>
<td>Gut Feeling (Of the Banker)</td>
<td>6</td>
<td>Repayment Capacity</td>
<td>9</td>
</tr>
<tr>
<td>History</td>
<td>3</td>
<td>Solvency</td>
<td>9</td>
</tr>
<tr>
<td>Industry Specifics</td>
<td>9</td>
<td>The Owner’s Private Finances</td>
<td>4</td>
</tr>
<tr>
<td>Internal Discipline</td>
<td>9</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Key Individuals (In the Firm)</td>
<td>9</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Outlook</td>
<td>5</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Relationship (Between the Owner and the Bank)</td>
<td>7</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Suppliers</td>
<td>3</td>
<td></td>
<td></td>
</tr>
<tr>
<td>The Overall Picture of the Form</td>
<td>5</td>
<td></td>
<td></td>
</tr>
<tr>
<td>The owner/Individual</td>
<td>10</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Transparency</td>
<td>3</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Trust</td>
<td>1</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Willingness to Add More Money Into the Business</td>
<td>5</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Source: The Authors

It also became evident that the different banks participating in the study work according to similar process in their credit risk evaluation of SMEs. However, the main point found was that the differences lie within what is being assessed by the various banks, rather than the processes.

Regarding S&P’s credit rating assessment, the findings point towards that their evaluation tends to lean towards more quantitative measures and techniques than the participating banks. Whereas, qualitative measures as relationship which are an important criteria for banks cannot be applied by S&P as they should provide independent and unbiased opinions regarding the corporate’s financial profile. Also found was that S&P conducts a more deep analysis, as the large firms and national governments being rated tend to have more complex structures and thus more factors need to be assessed.
7. CONCLUSION

In this chapter the conclusions made based on the empirical findings will be presented. Firstly, the research question and the two sub-questions will be answered, followed by a discussion regarding the fulfilment of the purpose of the thesis and contributions made. Thereafter, a deliberation upon the limitations of the study and suggestions for further research are presented. Lastly, the chapter is concluded by addressing different societal aspects in regard to the research at hand.

7.1 Answering the Research Problem

Since the latest financial crisis, a vast amount of research has been devoted to credit risk management and credit risk evaluation. Though, the field of research has largely been dominated by quantitative criteria and variables in terms of analysing credit risk. As a result a majority of models evaluating credit risk are numerical or statistical and mainly focus on large firms, leaving an unexplored gap regarding the level of qualitative information used in the credit risk assessment of smaller firms. The authors of the thesis also found it interesting to compare the results regarding criteria used assessing credit risk on small firms to criteria used by S&P as their main target are large firms or governments. This led the authors of the thesis to establish the research question presented below and the two following sub-questions.

However, before providing any answers and conclusions in terms of the stated research questions, the authors of the thesis find it important to consider the underlying purpose of the thesis and the chosen methodological path. Due to the fact that the research topic of the thesis is rarely discussed within existing empirical research, the authors found an exploratory and partly descriptive research design. That said, the aim of the thesis at hand is not to explain the current credit risk evaluation processes employed by Swedish banks, but rather to provide an initial foundation of fact as to build further research upon through exploration.

7.1.1 The Credit Risk Evaluation

In chapter one the following research question was stated, “How do banks evaluate credit risk of SMEs in Sweden?” The evaluation processes of credit risk were shown to be similar between the different banks except from one bank, which had a somewhat different order of the evaluation. What was evident was that the main thing that distinguishes the banks from one and other is which criteria that are used in the evaluation, and not the actual process. As established within the analysis, advisors within the same bank work according to the same structure and process however, when conducting the credit risk assessment the criteria found differed from advisor to advisor. The most commonly mentioned criteria used by the advisors were budget, business plan, customer’s customers, internal and external discipline, financial statements, industry specifics, historical accounts, key individuals, relationship, repayment capacity and the owner/individual.

It was concluded that the qualitative criterion of assessing the individual majorly impacts the credit risk evaluation. However, quantitative ratios and figures need to be somewhat acceptable, but if the advisor feels that the individual is the right person for the bank to do business with the bank can always find a solution. In terms of answering the question it was established that the credit risk evaluation employed by the participating banks are divided into
a qualitative and a quantitative assessment, where the overall impression of the firm is what matters in the end.

When putting the results into relation to the research gap established by the authors of the thesis at hand, the lack of research regarding criteria used by banks when evaluating credit risk of SMEs in Sweden was evident. The authors of the thesis argue that with this new knowledge regarding criteria found to be used by banks in their evaluation provided in figure 6.1, the research gap has been minored. However, the gap can still be further explored and more deeply covered, which will be further addressed in section 7.3.

7.1.2 Qualitative Criteria

The first sub-question was formulated, “What are the qualitative criteria used by banks when evaluating credit risk of SMEs in Sweden?” As an answer the question, the authors of the thesis have provided a list of the qualitative criteria that in the empirical findings was established to be used by banks in their evaluation of credit risk of SMEs, as presented in table 7.1. However, in regards to the purpose of the thesis, which was to explore what qualitative criteria that are used by banks, the authors will not further explain or describe the criteria found.

Table 7.1 Qualitative Criteria Used in Credit Risk Assessment

<table>
<thead>
<tr>
<th>Qualitative Criteria</th>
<th>Occurrence</th>
</tr>
</thead>
<tbody>
<tr>
<td>The Owner/Individual</td>
<td>10</td>
</tr>
<tr>
<td>Industry Specifics</td>
<td>9</td>
</tr>
<tr>
<td>Internal Discipline</td>
<td>9</td>
</tr>
<tr>
<td>Key Individuals (In the Firm)</td>
<td>9</td>
</tr>
<tr>
<td>Business Plan</td>
<td>8</td>
</tr>
<tr>
<td>External Discipline</td>
<td>8</td>
</tr>
<tr>
<td>Customer’s Customers</td>
<td>7</td>
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<tr>
<td>Relationship (Between Owner and the Bank)</td>
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<tr>
<td>Contracts</td>
<td>6</td>
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<td>Gut Feeling (of the Banker)</td>
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<td>History</td>
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<td>Suppliers</td>
<td>3</td>
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<tr>
<td>Transparency</td>
<td>3</td>
</tr>
<tr>
<td>Environmental Activities</td>
<td>2</td>
</tr>
<tr>
<td>Ethics</td>
<td>2</td>
</tr>
<tr>
<td>Trust</td>
<td>1</td>
</tr>
</tbody>
</table>

Source: The Authors
7.1.3 A Comparison with Standard and Poor’s

The second sub-question was stated, “Are these criteria similar to the criteria used by Standard & Poor’s in their rating model?” When comparing the criteria used by S&P and the criteria found used by the participating banks, several differences were seen. Both S&P and the financial institutions assess various quantitative measures evaluating the firms, among them cash flow and the repayment capacity were found. However, it was evident that S&P often makes more complex analyses in their evaluation, where e.g. capital structure, legal risk and country risk are assessed. None of these measures was found to be of importance when banks evaluate SMEs, the authors are made to believe that the difference are due to that the large firms being rated generally have a more complex structure, thus the evaluation has to become more thorough.

Regarding qualitative criteria S&P mentioned that they incorporate law risk, financial system risk, institutional and governance effectiveness risk and a firm’s competitive advantages in their evaluation. Compared to the qualitative criteria used by banks where the most common criteria to assess are the owner/individual, key individuals and relationship, there is a big difference. As S&P’s ratings are to reflect their independent and unbiased opinion regarding the firm's financial situation, they cannot build relationships and value them in their assessment as the banks does. Also, the owner/individual, which evidently was detected to be very important in the banks’ credit risk evaluation, is not presented by S&P.

Thus, the evaluation of credit risk differs in terms of S&P mostly using quantitative measures in their evaluation, whereas banks looks at the overall picture of the quantitative and qualitative criteria. Also, the assessment diverges in terms of the criteria used, where the largest differences are to be seen regarding the qualitative criteria.

7.2 Fulfilment of Purpose

Revisiting the fundamental aim of the thesis at hand as discussed in chapter one, the authors stated that “The purpose of the thesis at hand is to explore which qualitative criteria Swedish banks use in their credit risk assessment of SMEs in the context of the credit granting decision as to be able to provide new empirical evidence to the area”. Through the collection of rich empirical data, the authors of the study were able to establish a coherent list of qualitative criteria as to provide new valuable insight to the area. Hence, it can also be concluded that while there is still a need for continuous research regarding credit risk evaluation of SMEs, the overall purpose of the thesis have successfully been fulfilled.

Further stated was that “The authors also aim to compare the findings made with the current credit risk evaluation process employed by S&P as to detect any similarities in criteria used when evaluating SMEs and large corporations”. Through the compilation of a list of criteria used by the banks taking part in the study, the authors were able to easily compare the findings made to the information regarding the evaluation process of S&P. While little evidence of similarities was detected, the aim was merely to investigate whether there were any similarities, and consequently the authors find that also this purpose has been fulfilled.
7.3 Fulfilment of Contributions

7.3.1 Theoretical Contributions

The authors also aimed to make several contributions in terms of new valuable insight regarding the research topic. As previously pointed out, there is relatively little empirical research available regarding the credit risk evaluation process employed by banks, especially in terms of the qualitative criteria incorporated within the risk assessment. Hence, the authors of the thesis strived to also make certain theoretical contributions as from which further research may be based. By answering the stated research questions and providing a coherent list of criteria established to be used by Swedish banks, the authors believe that they were able to make also a valuable theoretical contribution to the field. This seen in terms of a valuable foundation as to build further empirical research on, and the authors of the thesis argue that by initiating an exploration within the area, there might be an increased incentive for continuous studies.

7.3.2 Practical Contributions

By answering the stated research questions, and consequently fulfilling the purpose of the thesis at hand, the authors also aimed to make certain practical contributions towards the Swedish banking sector. Given the empirical findings made, the authors of the thesis were able to initiate a description of the internal credit risk evaluation processes and practices employed by five of the six largest Swedish banks and present a coherent list of criteria used within these credit risk evaluation processes. As a result, the findings of the thesis contribute with a sound basis of information that may be used as a benchmark against which both the financial institutions participating within the study as well as smaller banks offering corporate loans can compare their own practices.

As earlier mentioned there is little empirical work available concerning the means and methods employed by banks when evaluating credit risk of SMEs. Therefore the authors also wanted to make a contribution in terms of clarifying the credit granting process such that SME owners understand what factors that they are evaluated upon when seeking credit and thus become better prepared when seeking a loan. By providing empirical evidence of how the credit risk evaluation process takes place, and a coherent list of qualitative and quantitative criteria used, the authors are bound to believe that this aimed contribution has been successfully fulfilled. As a consequence, if business owners become better prepared the corporate advisors might save time and resources by not having to request additional information and meetings, which in turn also will be beneficial to the bank.

Seen as the different criteria incorporated within the credit risk assessment employed by banks are not publicly available another contribution was seen in that a comparison against the criteria used by S&P within their credit rating model could aid investors as to evaluate unlisted firms. However, as concluded within the previous section, little empirical evidence was found suggesting that the credit risk evaluation model used by S&P might be used by investors as to evaluate Swedish SMEs. As a consequence, the authors were not able to fulfil the intended contribution, however important empirical evidence has been provided showing upon a distinct difference in the way SMEs and large corporations are evaluated and that there is a need of further research regarding these alteration in practises.
7.4 Limitations of the Study and Suggestions for Further Research

There are several areas that could be further developed and explored in order to gain more insight, as the topic of the thesis is rather unexplored. As of the unknown subject the authors of the thesis limited the study to only assess which criteria that are used by banks, and not to evaluate the criteria. Therefore as the authors has taken a first step and established a list of criteria used, further research could extend the findings made and more deeply assess if some criteria are more important than others and if the use of criteria differs among the banks. Further, the authors found the discussions regarding the individual or owner behind the firm seeking a credit to be rather vague, and as the authors of the thesis did not aim to provide any explanations to the criteria found, one specific suggestion would to further investigate how the criterion “Individual” is defined and evaluated.

Due to the limited time and the authors’ location, the study is based on 10 participants from 5 of the 6 largest banks in the northern part of Sweden. Though the authors of the thesis argue that their findings are valid enough to be generalized as the banks state that they work according to the same policy independent of which office the customer visits. It would have been interesting to establish if there are any differences in the criteria used nationally, as specific industries might be more common in one place than others and if this affects the use of criteria. Also, the authors of the thesis believe that expanding the number of participants and including all the six largest banks in the study could provide more insight to the subject.

The authors of the thesis took the perspective of the financial intuition and how they evaluate SMEs. Therefore, it would have been very interesting to do a replica of the study but in the perspective of SMEs to assess if the criteria used by banks are equal to what the firms perceive that they are evaluated on. As it was stated in the theoretical frame of reference, small firms can easier obtain a loan if they know what they are evaluated by, thus, are to SMEs and financial institutions share the same view of what they evaluate.

Something that became evident during the study was the importance of the individual in the assessment of credit risk when granting a loan to firms. Many of the participants mentioned that when evaluating the individual they commonly trust their gut feeling. However, trusting the gut feeling is rather vague, and hence a suggestion for further research is to assess if special characteristics can explain the advisor’s gut feeling, or how an advisor are to evaluate an individual as of now the assessment is rather subjective depending on the advisor.

In terms of the second sub-question, the authors limited themselves to only compare the findings of criteria used by banks to one of the large credit rating agencies. An extension of the thesis at hand could be through the incorporation of all of the three largest rating agencies or the two not used as to assess if there are any similarities to the criteria used evaluating SMEs.

7.5 Societal Considerations

As the topic of the thesis touches upon a rather sensitive area, it is important to the authors of the thesis to keep in mind how the findings might affect the society. Further, due to the fact that the topic of the thesis is rather unexplored new empirical findings have been established, and thus a discussion regarding societal considerations is needed as to evaluate the implications and effects of the study.
Something that became evident in the empirical findings was that the banks have sharpened the requirements on their corporate clients. Banks do no longer accept firms with questionable practises, and the environmental aspects were also emphasised as to be more important than ever. Thus, if the authors of the thesis are able to increase the awareness of these criteria SMEs may adjust their practices in regards to these findings and as a result create a better business climate with sounder and more environmentally friendly activities.

Due to the restricted access to external capital, SMEs tend to be heavily reliant on bank loans. However evident to the authors of the thesis was also that banks want to grant credits that in the end will be profitable deals. As a consequence, firms operating within areas with restricted growth opportunities, such as the northern hinterlands of Sweden, will face much greater barriers as to gain a bank loan. In light of the many business closures and cutbacks seen in the northern parts of Sweden encouraging local entrepreneurship is utmost important to the survival of rural areas. Thus, the authors of the thesis argue that Swedish banks hold a great responsibility in regards to the future development of these areas.

Lastly, as empirically and theoretically proven, owners of SMEs often find it difficult as to seek external financing, which is seen as a problem as these firms constitute the foundation of the Swedish business sector. Evident to the authors of the thesis was that the credit evaluation process employed by Swedish banks are often perceived as complex and uncertain and that owners of Swedish SMEs do not know exactly what factors that they are being assessed by. By establishing a coherent overview of the credit evaluation process and a clear list of criteria employed by Swedish banks, the authors hope to shed certain light on the topic and to encourage small business owners to seek external financing.


Appendix 1: The Information Sheet

Information Sheet Interview

The Purpose of the degree project
We are two students at Umeå School of Business and Economics, currently writing our degree project within the field of financial management. We aim to explore the criteria used by Swedish banks when granting credit to Small and Medium Sized Enterprises. That is to further investigate whether there are any similarities in terms of credit risk evaluation among Swedish banks and the large credit rating agencies. The reason for doing this is due to the fact that current empirical research mainly is focused towards quantitative criteria, e.g. key ratios, and rarely touches upon qualitative factors such as management. As a consequence, we aim to emphasize these qualitative criteria.

The respondents participating in the study consists of corporate advisors with small and medium sized companies as clients, currently employees at five of the six largest banks in Sweden. Between one to four individuals representing each bank will be interviewed at separate occasions. In order for us to be able to meet you all in person, we have decided to conduct interviews with employees at the offices in Umeå and in Sundsvall.

What does participation entail?
The interviews will be held during week 11 and 12, with room or change, and are expected to take approximately one hour. At the interview only you as the respondent and us (Maria and Johanna) will be participating. The purpose of the interviews is to gain a deeper understanding regarding the different criteria used when granting credit through open questions and discussion. Hence, it is also important that you as the respondent feel prepared as to participate in a profound discussion.

Participation is of course voluntary, and all participants are free to choose whether to respond to a certain question or not. You as a respondent will receive full anonymity and has the right to end the interview at any time.

Before the interview start, we will all sign a contract (see next page) as to ensure anonymity for all participants, that you as a participant is aware of what participations entail and that you approve or audio recording of the entire interview.

Data collection and handling information
The data collected will be compiled and analysed as to later be presented within the thesis. As a consequence, the information will be regarded at a public document available to the general public. When the thesis has been accepted by the grading committee, it will be published in the Academic Archive Online called “Digitale Vetenskapliga Arkivet” (DIVA). Throughout the thesis, no bank or individual will be mentioned or described in such a way that any recognition will be possible.

Source: The Authors
Appendix 2: Interview Set-up

Interview set-up

The interviews will be conducted as semi-structured discussions, where the main point is that you as the respondent will have the possibility to speak freely regarding the subjects that we aim to investigate. In order for you as the participant to feel as comfortable as possible, we will present the topics that will be discussed throughout the interview, however no specific questions will be revealed in advance.

During the interview the following topics will be discussed:

- The background and previous experience of the participant
  A short presentation of yourself as to give us a better assessment of you and your previous experiences.

- Summary of clientele:
  An overall description of e.g. the geographical spread and size of corporate clients.

- Decision making process when granting credit
  How is the credit granting process structured, and what steps are included throughout the process?

- Different criteria for credit risk evaluation
  Discussion regarding qualitative and quantitative criteria.

Source: The Authors
Appendix 3: Consent Form

Informed consent

I confirm that I have read and understood the information provided to me in the information sheet that I was provided before the interview.

I understand that my participation is voluntary, and that I have the right to finish the interview at any time.

I agree to take part in the study.

I agree to the interview being audio recorded.

I agree to the use of eventual anonymous quotes being incorporated in the thesis.

______________________________
City and Date

______________________________
Name

______________________________
Position

______________________________
Johanna Linjamaa  
______________________________
Maria Hörstedt

Source: The Authors
Appendix 4: Interview Guide

Interview guide

The background and previous experience of the participant
Can you tell us a little bit about yourself and your previous experiences?
Can you describe your career?
How long have you been working within the bank?
How long have you been working as a corporate advisor?
Can you explain your work tasks?

Summary of clientele
Can you describe your clientele?
- In terms of size, geographical spread, industry etc.
Do you familiarize yourself with the different operations of your customers?
How do you keep yourself up to date regarding different industries?

Different criteria for credit risk evaluation
Can you describe the criteria used in the process of granting credit?
- In terms of a start-up and existing company
Are some criteria more important than other?
- Why/why not?
Is there any specific policy within the bank regarding the criteria that are to be used?
What/Who determines which criteria you should use?
Are there specific criteria depending on the situation and/or the customer?
Do the criteria used differ if the client asks for a short-term or long-term loan?
Do you employ any tools or models when evaluating credit risk?
- If yes, can you describe these tools or models?
- How do you use it/them?
Part from the criteria that you have mentioned, are there any criteria that you feel should be added to the evaluation process of credit risk among SMEs?

Decision-making process when granting credit
Can you guide us through a credit decision?
- In terms of a start-up and existing company
Do you evaluate the company by yourself?
What criteria could raise red flags?
Do you have the authority to take all decisions?

Summing up
Can you summarize the qualitative and quantitative criteria that you use?
Do you want to add something?
Do you have any questions?

Source: The Authors