2.0 Background Research

The development of the Small Medium Entrepreneurs (SMEs) is known as an important element of a nation's economy. Malaysian SMEs representing 99.2% of total business establishments and employing over 5.6 million workers creating a balanced economic development with higher standards of living at all levels of society (NSDC, 2007). Following the global financial crisis, most advanced economies are expected to grow at a slower rate hence; Malaysia's economy has recorded a steady economic growth and sign of recovery. Based on the strong economic fundamentals and a diversified economy, the banking system in Malaysia still showed a positive and flexibility in asset quality. However, the banking sectors expected a high default cases especially from SMEs, due to the inflation from instability of global oil and food prices.

It is important for an organization especially SMEs to stay competitive and survive in the era of globalization and liberalization. In achieving a competitive, productive and resilient SME sector, the Malaysian Government is focusing on programmes to enhance SME competitiveness locally and globally. Hence, the SMEs have to play an important role in realizing the effort by taking advantage on the changing economic environment both domestically and abroad.

2.1 Financial Institution

In the fast moving business environment, SMEs need to equip themselves with all the experience and knowledge to survive in the business world. Today, SMEs are not competing within their circle of business but also from bigger corporation. Sharing niche market share with bigger companies requires SMEs to be more competitive and need to minimize their business challenges. The development of Malaysian SMEs is phenomenal, contributing significantly to the economic growth process over the years (BNM, 2005). In spite rapid development, little effort had been conducted to identify challenges faced by SMEs. It is important to recognize the challenges as it would assist both the government and industries player to take necessary action to mitigate and overcome the identified problems (Saleh & Kupusamy, 2007). Previous study by (Saleh & Kupusamy, 2007) had identified six major pre-determined challenges faced by SMEs, one of the challenges was **inaccessibility to finance**.

Government under the role development of SMEs has emphasized on the financing initiatives. It is to strengthen the finance providers (banks) and also to widen the avenues of financing. The establishment of Small Medium Enterprise Bank or Bank Perusahaan Kecil & Sederhana Malaysia Berhad (SME Bank) in October 3rd, 2005 is to dedicate to the accelerated growth of Malaysian and enables SMEs to access the necessary amount and types of financing to their business life-cycle. SME Bank is designed to function ultimately as a one-stop financing and business development centre and with a vision to become the SME Hub by 2010. The principal activities of the Bank are to provide financing as well as financial and business advisory services to Malaysian SMEs residing within predefined categories which have been framed within the SME classification guidelines of the National SME Development Council (SME Bank website).

Parts from SME Bank, other financial institutions have prioritized provision to finance SMEs with comprehensive financing solutions. As a result, financing for SMEs has expanding significantly (NSDC). New strategies and initiatives are being taken to improve SME access to financing, in 2007, RM2.4 billion had been allocated to various Ministries and agencies promoting SMEs. In 2008, additional of RM2.1 billion had been channeled to SMEs via SME Bank and six other commercial banks. Based from Bank Negara Report, financing outstanding to SMEs stood at RM128 billion to over 625,000 SMEs by the banking institutions and Development Financial Institutions (DFIs). The share of SME financing against total business financing also remained high and stable with SME financing accounting for 44.3% of total business financing by the end of March 2008. To further enhance SME access to financing in 2008, banking institutions and DFIs have targeted a total of RM70 billion as financing to 140,000 SME accounts (BNM). There is significant expansion on the amount approved by the financial institution, according to BNM 2007 report, a total of RM63.2 billion loans had been approved to over 132,000 SMEs throughout the country. The number had exceeded the targeted loans approved of RM51billion which was projected to finance 110,000 SMEs.

SMEs are contributing not only in Malaysia but everywhere in the world. Generally, SMEs are the main contributors to the country's economic growth. Some countries especially the developed and developing countries do establish their own financial institution or agencies which responsible to the development of SMEs. The current trends in the banking markets in the new member states of the European Union (EU) may seem puzzling. On the one hand, they are attractive targets for Western European banks that now posses most of the banks assets in nearly all the countries of this region. Currently, the investments made by foreign banks in these countries pay off, and actually generate higher revenues than their activities in their home markets (Breyer, 2004). Still, many firms in the new member states complain that access to finance represents a major impediment to doing business. SMEs find it particularly difficult to get loans as in Eastern Europe, only about 45 per cent of SMEs use external finance while 65 per cent of the large firms do so (Fidrmuc, Hainz & Malesich). This means that, due to the lack of financial intermediation, their potential contributions to growth and employment are wasted (Bilsen and Konings, 1998, Levine, 2006). There is a study on the level of loan delinquency, and the lending practices of the country's bankers towards the SMEs in Nigeria (Obamuyi, 2007).

Basically, small and medium enterprises in Nigeria are expected to raise funds from two main sources: Equity and Debt. The sources of equity (sometimes called internal funds) include owners' savings and ploughed back profits. Funds from external source (debt) can be obtained from informal sources (that is friends/relatives, credit associations co-operative societies for example) and formal sources (that is banks, governmental agencies for example). The result is similar to everywhere in the world, accessibility to formal financial system is very limited.

Finance is also a critical factor for SMEs to growth and survival. Previous studies have found that the SMEs face difficulty in acquiring external funds to finance their short term and long-term business needs (Rahman, Mahmood & Abd. Rahman). The constraints is their size, as they do not have direct access for the equity financing in the capital market, and therefore they have to rely to a much greater extent on bank loans (Strahan & Weston, 1998). Even when these SMEs are well established, still most of the businesses find that banks have perceived them as high risk and low margin borrowers. Such claims that the banks emphasize mainly on large customers and they are not sympathetic and tend to neglect smaller ones (Buerger & Ulrich, 1986).

Based on previous studies, SMEs are deprived of funds due to the lack of understanding on the part of bankers and the small business owners (Rahman, Mahmood & Abd Rahman). Realistically, the relationship between SMEs as the borrower and a bank should be relatively easy to maintain; when the borrower has the needs to obtain financing assistance and the bank has the means to fulfill these needs. However, according to (Read, 1998 & Lister 1991), this relationship is not that simple, the researcher found it too problematic, and frequently being characterized by negative feelings toward the banks.

Based on earlier study, gaps in the relationship do exist, especially in relation to debt financing (Stanworth & Gray, 1991). Banks are very particular in term of the sizes of SMEs as; small businesses may generate little income to them. Banks perceived this as marginally profitable relationship. However, with the current scenario Banks have created a closer relationship with the small businesses sector of the latter's recognition of the potential profitability the sector provides (Rahman, Mahmood & Abd. Rahman). SMEs now constitutes a significant force in the economy, the Bank will miss big opportunity if they still reluctant to extend financing to these businesses.

Banks earn higher profit rates on small business loans than on other assets as small business lending becomes a very attractive source of income for the banks (Churchill & Lewis, 1985). Furthermore, lending to large customer becoming less attractive due to the increasingly competitive environment coupled with the deregulation of the banking industry. Such limitation and procedures can lead to smaller margins if all banks focus mainly on large customers. Nowadays, large customers too are well equip with alternative source of funding through the capital market, given them the negotiation advantage over the loan pricing. As a result, large business customers may no longer being the profit centre to the banks.

Banks are not expanding SMEs loans due to inadequate capital, imperfect information, high transaction cost of dealing with small loans, geographical dispersion of the SMEs and large number of borrowers and low returns from investment. However, SMEs are reluctant to obtain loans because of the collateral security, high interest rate, untimely delivery of credits, and other things (Obamuyi, 2007). Result from the previous study revealed that sound-lending policy demands that for those small and medium enterprises that the bankers believe they have high probabilities of default, loan applications are not approved. Others problem faced by SMEs is in the lack of resources (Gemser, Brand and Sorge, 2004). According to Gemser, Brand and Sorge (2004), SMEs often suffers from the lack of those resources that provide economies of scale and reducing cost.

According to Ting (2004), challenges faced by Malaysian SMEs also include human resource constraints; **lack of access to finance**; inability to adopt technology and lack of information on potential markets. He also argued that Malaysian SMEs are in a critical position to be wiped out if they do not improve their competitiveness in the near future. A pilot study had been conducted on 100 Malaysian SMEs and the result showed that labour cost, **innovation and access to funding** and working capital are the main challenges facing Malaysian SMEs (Saleh & Kupusamy, 2007). Saleh and Ndubisi (2006) identified key challenges faced by Malaysian SMEs as below:-

High bureaucracy in government agencies hinders efficient business development. Malaysian SMEs often face difficulty in obtaining funds from the banks institutions as well as from the government. **Lack of human capital** is one of the most significant challenges for Malaysian SMEs. It is often very expensive for Malaysian SMEs to employ professional and skilled people. SMEs also facing **high level of international competition** due to globalization; such as AFTA and MNCs or new competitors (e.g., China, India).

2.2 Non Performing Loans (NPLs)

There is no universal standard to define NPLs at the practical level. Variations exist in terms of the classification system, the scope, and contents. According to (Hou), a simple definition; A loan that is not earning income and:

(1) Full payment of principal and interest is no longer anticipated,

(2) Principal or interest is 90 days or more delinquent, or

(3) The maturity date has passed and payment in full has not been made.

Other definition, a non-performing loan is a loan that is in default or close to being in default. It is known that, many loans become non-performing after being in default for 3 months, but this can depend on the contract terms. “A loan is non performing when payments of interest and principal are past due by 90 days or more, or at least 90 days of interest payments have been capitalized, refinanced or delayed by agreement, or payments are less than 90 days overdue, but there are other good reasons to doubt that payments will be made in full” (IMF).

The issue of non-performing loans (NPLs) has created greater issues in the financial institution especially in Malaysia. High default rates in SMEs lending should be of major concern to policy makers in developing countries, because of its unintended negative impacts on SMEs financing (Obamuyi, 2007). Although the rate of NPLs showed a decreased, still there is tendency of these NPLs rate to increase. Banks should have counter measures on how to overcome these problems and address those issues involving the performance of SMEs and also strategic management solves the NPLs problems.

According to Bank Negara report, SMEs' access to financing increased, the quality of SME financing has also improved, with SME gross non- performing loan ratio declining to 9.1% from 11.1% in 2007, resulting from stronger risk management by the financial institutions and supported further by the sustained debt servicing capacity of SMEs. However, immediate consequences of large amount of NPLs in the banking system are bank failure. Many researches on the cause of bank failures find that asset quality is a statistically significant predictor of insolvency (Dermirgue-Kunt 1989, Barr and Siems 1994). It is argued that the non-performing loans are one of the major causes of the economic stagnation problems (Hou). Each non-performing loan in the financial sector is viewed as an ailing unprofitable enterprise. If the non-performing loans are continued to exist, it would paralyze the economic growth and impairing the economic efficiency.

In this paper, the discussion focuses on the Rehabilitations of the Non-Performing Loans in SME Bank. It is to evaluate the current process flow and to improvised and enhanced the process flow. However, there are some constraints and limitations on data for NPLs. The data for NPLs is very restricted, due to SME Bank being one of the government agencies is govern by the Development Financial Act 2002 (DAFIA). This act protect the rights and information of the Bank’s customers as well as information involving loans such as approval rate, NPLs and disbursement amount.

According to Se-Hark Park (2003), the U.S., federal regulated banks to use the five-tier non-performing loan classification system according to BIS: Pass, Special Mention, Substandard, Doubtful, and Loss. Presently, the five-tier system is the most popular risk classification method, and as a dual system of reporting according to their domestic policy guidelines as well as the five-tier system. According to BIS, the standard loan classifications are defined as follows:

- **Passed**: Solvent loans;
- **Special Mention**: Loans to enterprises which may pose some collection difficulties, for instance, because of continuing business losses;

- **Substandard**: Loans whose interest or principal payments are longer than three months in arrears of lending conditions are eased. The banks make 10% provision for the unsecured portion of the loans classified as substandard;

- **Doubtful**: Full liquidation of outstanding debts appears doubtful and the accounts suggest that there will be a loss, the exact amount of which cannot be determined as yet. Banks make 50% provision for doubtful loans;

- **Virtual Loss and Loss (Unrecoverable)**: Outstanding debts are regarded as not collectable, usually loans to firms which applied for legal resolution and protection under bankruptcy laws. Banks make 100% provision for loss loans.

Based from the above explanation, the non-performing loans comprise the loans within the first three categories, and are further differentiated according to the degree of collection difficulties. According to (Hou), efforts have been made to improve and standardized the classification of loans. Focuses on the recognition and measurement of financial instruments defines and establishes the measurement and evaluation of impaired loans (The International Accounting Standard 39 revised in 2003). The initiation of this standard is to prevent banks from being at risk if the borrowers go bankrupt due to little or no loss provision for impaired loans. Currently, many global economists, rating agencies, and organisations such as the World Bank and the Asian Development Bank have begun to evaluate the effects of NPLs on GDP growth by estimating growth rate to reflect the time and cost of resolving large non-performing loan issues.

An expansion of credit especially loans to small business may increase the probability of a banking crisis if, during the credit boom period, the quality of the evaluation of credit proposals suffers. Although, there was a study on default of bank loans is on syndicated loans to corporate debtors (Altman and Suggitt, 2000). The only missing evidence is on the default pattern of loans to individual firms in a fast growing emerging economy. (Fidrmuc, Hainz & Malesich, 2006) According to Small Medium Industries Development Corporation (SMIDEC), billions had been allocated to SMEs in Malaysia, to promote the development of SMEs in the country. However, SMEs tend to have difficulties in accessing these funds because of a lack of transparency in their business disclosure (Saleh & Ndubisi, 2006).

To overcome the problem, SMEs must be able to disclose their financial status, repayment records and managerial capabilities to allow financial institutions to formulate objective financial assessments. The government has taken measures to reduce the financing cost and increase accessibility by relaxing loan conditions (for example interest rates, and substituting collateral requirements with securitization of cash flow). Part from that various initiative and programmes had been undertaken by SMIDEC, the Association of Chartered and Certified Accountants (ACCA) and financial institutions to educate SMEs of the importance of prudent financial management. (Saleh & Ndubisi, 2006)

In financing SMEs, the issues of non performing loans and loans default has been identified as one of the reason why banks show little interest in SMEs financing (Obamuyi, 2007). Loan default can be defined as the inability of a borrower to fulfill his or her loan obligation as at when due (Balogun and Alimi, 1990). Von-Pischke (1980) states that some of the impacts associated with default include: the inability to recycle funds to other borrowers; unwillingness of other financial intermediaries to serve the needs of small borrowers; and the creation of distrust. As noted by Baku and Smith (1998), for the SMEs (borrower), the decision to default is a trade-off between the penalties in lost reputation from default versus the opportunity cost of forgoing investments due to working out the current loan.

Non-performing loans have been viewed to constitute one of the most important factors causing reluctance for the banks to provide credit. In a high NPL condition, banks increasingly tend to carry out internal consolidation to improve the asset quality rather than distributing credit. Problem with the non-performing loans can lead to efficiency problem in the banking system. Prior research by economists found that failing banks tend to be located far from the most-efficient frontier (Berger and Humphrey (1992), Barr and Siems (1994), because banks don’t optimize their portfolio decisions by lending less than demanded. Evidences showed that even among successful banks, there is a negative relationship between the non-performing loans and performance efficiency (Kwan and Eisenbeis (1994), Hughes & Moon (1995), Resti (1995).

Because of the high NPLs caused by SMEs, banks are reluctant to take new risks and commit new loans. This action is described as the ‘”credit crunch” problem. A “credit crunch” is a disequilibrium phenomenon, when banks are unwilling to lend, especially when a firm with profitable projects cannot obtain credit in spite of low interest rates (Hou). Credit crunch is “a situation in which the supply of credit is restricted below the range usually identified with prevailing market interest rates and the profitability of investment projects. (United States Council of Economic Advisors, 1991). High level of NPLs requires banks to raise provision for loan loss that decreases the banks’ revenue and reduces the funds for new lending. The cutback of loans impairs the corporate sector as they have difficulties in expanding their working capital, blocking their chances of resuming normal operation or growing. According to Hou, a poor economic condition and the depressed economic growth, the level of NPLs increases leads to the weaker corporate sector makes banks more reluctant to provide additional credits and with insufficient capital, the production sector is further weakened, resulting in decreases in aggregate demand , and it will be even worse when SMEs (borrowers) condition creates more NPLs.

Study done by Agung et. al. (2001) in Indonesia revealed that the relationship between the loan supply and real lending capacity, lending rates, real out put, bank's capital ratio, and non-performing loan show that the coefficients on NPLs are negative and significant, which indicate that bank credit supply declines with the worsening of the NPLs problem. Previous study on the effects of non performing loans according to Hou, is the empirical methodology used to test the effects on non performing loans. An increased in non-performing loans can cause the decline in commercial bank credits, as banks with high level of non-performing loans in their portfolio may become reluctant to take up new risks and commit new loans. That means, NPLs have a negative effect on loans, implying that the higher NPLs in a bank's portfolio, the less credit that the bank can and is willing to supply.

2.3 Knowledge Management

Knowledge Management began in the early 1990's when organizations in the business sector realized that tying together a company's knowledge and collective expertise, and distributing it to the right people at the right time is essential and can give the company a competitive edge. (Fourie, 2004) Since then, companies have invested large amounts of money in the development of knowledge management systems including tools and applications that capture knowledge effectively, promote efficient distribution, enhance intuitive usage and provide the ability to link concepts of knowledge to other sources. (Fourie, 2004)

It is proven that, when these systems are applied correctly by following knowledge focused approach with an inclination towards information technology, as well as through a culture created to encourage knowledge sharing and creation, companies often experience a large increase in their return on investment. (Fourie, 2004). Considering the need to evaluate the performance of the SME prior to processing and the rehabilitation of the loan, a specific knowledge management system must be present to provide information for the decision makers. More importantly, since the SME bank has branches that operate as the first contact of the SMEs, it is also necessary to ensure that the information travels accurately and quickly.

Rehman (2000) defines the function of the bank bluntly, “In a market driven system, banks are not designed to be development institutions or welfare agencies. Their primary goal remains to make the best possible profit for their bank shareholders. Thus, it is argued that if banks are to sustain themselves as profit making corporate entities they will be inclined to entrust their resources to those who can be relied upon to repay their loans with interest. Such borrowers should normally be people who use resources efficiently. However, efficiency is not always the dominant criterion for lending. Bank managers tend to be more influenced by the social structure of borrowers on the assumption that affluent citizens are likely to be more creditworthy and hence can be relied upon to repay their loans” (Rehman, 2000).

Rehman (2000) essentially states that the bank exists to make a profit. However, public owned banks such as the SME Bank do not have the pleasure of maximizing profit. They act as intermediaries to fuel the growth of small and medium enterprises to ensure a sustainable national growth. Because of this objective, the bank has to ensure that the small and medium enterprises’ projects succeed. Therefore, they need a knowledge management system, not only to help them recover the loans, but also to learn about the mistakes of past entrepreneurs.

In most cases, knowledge management systems are required to gain a competitive edge. In the case of the rehabilitation of loans, the knowledge system should cater to salvaging the remainder of the loans. As Fraser (2008) aptly puts it, “the challenge faced by traditional retail *banks* is that markets continue to shift; large financial institutions no longer gain an advantage based on economies of scale, because size and vertical organizational structures result in operational costs five times greater than the costs of nontraditional *banks.*” Therefore, these changing times require the banks to look at effective ways to gain competitive edge – particularly in the information arena.

Frasier (2008) even suggests a Virtual Network Organization (VNO) for banks to reduce operating costs, increase managerial efficiencies, and achieve greater advantages in economies of scale and asset. Furthermore, he adds, it may provide better opportunities for survivability and resiliency of the retail banking infrastructure in the event of a natural or manmade disaster. Finally, the use of the VNO model could provide opportunities to increase basis points on financial service products and facilitate access to a broader talent pool of *knowledge* capital, while allowing increased focus on the core competencies of financial services. (Frasier, 2008)

As per Huizing and Bouman definition, knowledge management is an organizational discipline bridging information demand and supply in support of learning processes within organizations. (Curado, 2008) Furthermore, it is expected to be the foundation of the twenty first century. Value is created when stocks of knowledge are employed and degrades when they remain unused. (Curado, 2008). Thus, applying knowledge management in business becomes a strategic issue.

Firms need to redefine their strategies and functions to compete in the knowledge era. The knowledge-based competitive advantage is sustainable because the more a firm already knows, the more it can learn. Knowledge management gathers its creation and transfer (Curado, 2008). In operating an SME Bank Rehabilitation Department, it is not only necessary to compile the information of the current financial status, but also to discover and compile the reasons the small and medium enterprises fail. The knowedge created by the organization is most likely to be difficult to be recreated or imitated by other organizations. It is impossible to create if the knowledge is developed and generated within the organization. The firm absorbs knowledge from internal and external sources, combines them with pre-acquired knowledge and is able to create new valuable knowledge. These combinations of pre-existing knowledge with new knowledge create new knowledge which further enhances the competitive edge.

In her research, Curado (2008) found the following, “Regarding the perspective interviewees have on what the banks consider to be ‘‘knowledge management’’ it is something related to training, strategic management and people’s knowledge. The perception of the interviewees on what the banks consider to be knowledge management is consistent with the daily examples of knowledge management given by them, especially when they mention training and strategic thinking. The perception of the interviewees on what the banks consider to be knowledge management seems to be very well reflected in the daily examples of knowledge management given by the interviewees.”

This essentially means that the banking employees generally limit the concept of knowledge management in the banking industry to training, strategic management and people’s knowledge. In the case of the SME Bank, it becomes imperative to collect and store the knowledge gained from small and medium sized enterprises, especially those that fail. The ability to look into the past and identify potential problems will be an added advantage since the bank will be able to foresee a loan default and help the entrepreneur effectively.

Fourie (2004) in his study found that a knowledge management system within the banking industry must provide a broad spectrum of knowledge. He adds that current employees are overloaded with a large amount of single knowledge sources without proper linkage or unified search functionality. These functions allow extended access to the different sources as well as delivery of high quality results.

He further adds that, in the banking industry, “although the company has implemented sophisticated information system technology, it provides only limited knowledge management facilities to its employees. Employees are able to publish and share specific knowledge in the Lotus Notes environment, on the bulletin board, “info-tiles”, and via e-mail. Lotus Notes provides a good information management system, but is basically used as a document management, e-mail and news distribution system in the company. Although these functionalities are relatively sophisticated, the system lacks substantial search functionality and a workflow management facility. The documents are not connected to cases, processes, or current projects in the company. The provided tools for knowledge gathering and knowledge distribution are thus currently not properly used for knowledge management and function more as an electronic newsletter.”

2.4 Relationship Management

Recent studies suggest that the latest development in information technology and telecommunication will aid in the creation of long term and sustainable relationship. In the SME Bank operations, the SME Bank will need to provide a comprehensive solution and aid before the borrower or entrepreneur faces a default. Thus, a clear communication line must be established which tracks the progress of the entrepreneur as well as developments of the project.

By employing information technology and an integrated knowledge management system, the bank reduces the cost of employees as well as resources in tracking the progress of the entrepreneur. In line with this, the entire organization must be should be responsible for the tracking and evaluation of entrepreneur. Saparito (2001) indicates that bank-small firm relationships have been primarily studied by finance scholars who generally conceptualize lender-borrower relationships using a principal-agent perspective. “Agency theory does little to explore the social-psychological factors within economic exchange, resulting *in* calls for alternative models which reflect the richness of bank-corporate relationships.” (Saparito, 2001)

Based on Saparito's statement above, we can indicate that the bank-entrepreneur relationship is as important as recovery of the loans. In other words, we are indicating that the process of loan recovery does not start from the moment the entrepreneurs default, but it begins the moment the first loan amount is drawn. However, managing this process is easier said than performed in reality. It is indicative of the level of trust that the bank can afford on the entrepreneur.

More importantly, it identifies a bank's extra efforts such as "helpfulness, information sharing, and flexibility as a relational strategy and suggests such strategies are a form of Porter's product differentiation strategy" (Saparito, 2001). Though the SME Bank has no real competition, its effect on developing the small and medium enterprises in Malaysia is enormous. Therefore, drawing upon Saparito above, the bank will need to look into the methods with which it entices the entrepreneur to maintain their loan repayment.

Trust is considered an indispensable factor in banking relationships. Bankers consider trust to be the foundation on which a small firm's loan structure is built. Likewise, the small firms trust that the banker will be there during bad times as well as good times. Essentially, the mutual trust between the two firms will be crucial in developing a long term relationship. (Saparito, 2001) Moreover, it will be the underlying fact when the loan is defaulted or in the process of recovery.

The above premise was adopted to avoid the view of humans as “a two legged calculators, efficient and cold-blooded”. Therefore, a look at the relationship model between the SME Bank and how the bank deals with the entrepreneurs will provide a better loan recovery solution. Trust is the willingness to be vulnerable. It is committing to an exchange before certain knowledge on how the other person will reciprocate. The willingness to be vulnerable suggests that the trustor is willing to take a risk by placing his or her welfare in the hands of another. (Saparito, 2001) In our case, the SME Bank has put its trust in the entrepreneur to pay back the loan rewarded. In other words, the current actions which SME Bank takes place the bank in a situation where the entrepreneurs’ future actions may adversely affect SME Bank’s welfare.

Saparito (2001) examines trust in three different dimensions. The first is called institutional based trust that flows from legal and financial systems that feature safeguards against and punishments for malfeasance. The second trust is called the process based trust that flows from past interactions and reputation. Finally, the characteristic based trust that is tied to ethnicity or familial ties. (Saparito, 2001) The SME Bank should capitalize on the trusts based on institution and process. Saparito (2001) also explores calculus based trust. This type of trust "emphasizes the pragmatic and rational consideration of self interest between the interdependent parties whose compliance is ensured through a system of punishment and rewards." This is essentially the trust that is established in normal banking systems. The loan is rewarded with the expectation of repayment with interest. However, in the case of a default by the entrepreneur, the bank has the necessary provisions to recover the loan through asset sales and foreclosure.

This belief is essentially grounded on the belief that the entrepreneurs' self motivation will create behaviors that are consistent with the Bank's interests. However, if this was the case, then the amount of loan defaulters or non performing loans will be small. This type of trusts factors in heavily punishments and rewards. In other words, the perceived reward should motivate the entrepreneurs while the punishment will entice the entrepreneur to avoid unfavorable behavior. (Saparito, 2001)

In the case of the SME Bank, the punishment and reward might not be well defined. The rewards will be entirely on the effort of the entrepreneur to succeed in his project while the punishment will be foreclosure. The legal regulations limit the amount that can be recovered by the bank. Hence, a calculus based trust as well as institutional based trust should be sufficient.

The second form of trust mentioned earlier – the process based trust – can be acquired by looking at the bank's relational strategy. The finance and banking literature notes that the bank's relational strategy often includes information sharing, helpfulness and flexibility. In other words, the bank should strive to build a lifetime relationship, not a one-time sale. (Saparito, 2001) The process based trust can be constructed from knowledge obtained regarding the entrepreneur. Recent developments suggest that the development and management of firm-bank relationships is in fact a two way process that seeks dialogue. (Saparito 2001) The dialogues are catered to help the exchange of information between the bankers (business plans from the firm, fee and terms of the bank) and the entrepreneurs (business forecasts, business advice and suggestions from bank). (Saparito, 2001)

These dialogues should give an indication on the possibility of a default and non performing loans. A discussion with the entrepreneurs regarding the problems faced by the SMEs should give an early indication of problem. This will enable the bankers to provide help before the loan is defaulted and further improve the non-performing loans of the bank. In the case of loans, a fuller understanding of the circumstances surrounding a business allows a bank to structure loans in such a fashion to facilitate payment ease.