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Lending decision making in banks: A critical incident study of loan officers ☆

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Summary Using the critical incident technique, we investigated how 88 loan officers at four Swedish banks perceived their decision making in evaluations of commercial loan applications. First, we found that our sample of loan officers primarily used deliberation and less intuition when making decisions. Second, that the loan officers had greater difficulty in making decisions that involved soft information (e.g., client relationships) than decisions that involved hard information (e.g., financial information). Third, most decision making situations involved existing rather than new clients and low rather than high risk levels. Finally, we found a potential effect of organizational factors such as lending practices on lending decisions. Our findings have general implications for research on decision making processes. For the banking industry, this research identifies and elucidates the difficulties loan officers face in decision making of commercial loans.
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1. Introduction

Research on decision making in banks has dealt with the effect of task characteristics on loan officers' decision making (Biggs, Bedard, Gaber, & Linsmeier, 1985), the influence of different information retrieval systems on credit risk decisions (Rodgers, 1991), and the influence of financial information on lending decisions (Casey, 1980). In their study, Biggs et al. (1985) concluded that bank loan officers who face increased task size use non-compensatory decision strategies (e.g., they neglect important evaluation information and make decisions based on a single criterion). If confronted with similar tasks simultaneously, loan officers tend to conduct a more thorough evaluation, using compensatory strategies. Loan officers who are characterized as data-driven (i.e., officers who use a bottom-up strategy when evaluating data and who focus on financial data) make more thorough evaluations of loan applicants than loan officers characterized as conceptually driven (i.e., officers who use a top-down strategy and who focus on the context and their expectations of the loan applicants) (Rodgers, 1991). Casey (1980), who demonstrate that loan officers with more information could not predict bankruptcy better than loan officers with considerably less information, suggests that information overload diminishes loan officers' ability to process information. Hwang and Lin (1999) provide support for this conclusion in their review which show that more information does not always result in better decisions and that the way in

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which information is presented is crucial for making good decisions. This decision making strategy is an example of the general less-is-more heuristic demonstrated by Gigerenzer in other domains than bank loan decisions (Gigerenzer & Gassmaier, 2011).

In recent years, researchers have distinguished between two processes that precede decisions (Kahneman, 2011; Sloman, 1996). The two processes differ based on the amount of cognitive effort involved in making decisions (Hogarth, 2001; Hogarth, 2010). Decisions requiring high cognitive effort can be described as deliberate and conscious, whereas decisions requiring low cognitive effort can be described as automatic and unconscious (Meyers, 2002). The latter process, which exists outside awareness, is referred to as intuition (Hogarth, 2005) or ''gut feel'' (Sadler-Smith & Shefy, 2004). Although gut feel is a manifestation of intuition and not identical with intuition the two terms are often used interchangeably (Harung, 1993; Parikh, 1994). Although the use of intuition in managerial decision making has long been acknowledged (Simon, 1987), it is still widely discussed (Dane & Pratt, 2007; Miller & Ireland, 2005; Sadler-Smith & Shefy, 2004).

There is some research on the use of intuition and its relationship with deliberative analysis in banking (e.g., Agor, 1986; Sadler-Smith, 2004). Two recent qualitative studies in particular shed new light on intuition in lending decision making (Hensman & Sadler-Smith, 2011; Lipshitz & Shulimovitz, 2007). Based on retrospective interviews with bank loan officers, these two studies conclude that loan officers regularly use intuition in credit decisions. Moreover, the loan officers in the two studies report that reliance on intuition (e.g., trusting their feelings about loan applications) may result in better evaluations of loan applicants' creditworthiness than reliance on deliberation (e.g., examining financial information).

Hensman and Sadler-Smith (2011) and others (e.g., Greifeneder, Bless, & Tuan Pham, 2011) have found that the use of intuition in decision making depends on situational factors (e.g., factors of time and uncertainty) and organizational factors (e.g., bank hierarchy), rather than only on individual factors (e.g., the lack of motivation that Chaiken and Trope (1999) describe). The importance and influence of situational factors on decision making have been much debated by researchers for a number of years (see, e.g., Gigerenzer, 2007; Hogarth & Karelaia, 2007). Kahneman and Klein (2009) emphasized the importance of situational factors on decision making in their theory of ''high-validity'' and ''low-validity settings''. In brief, high-validity settings are settings in which there is a stable relationship between cues and outcomes. In addition, it is required in such settings that there are a fixed number of possible outcomes as well as rules governing cues and outcomes. Low-validity settings are those in which the outcomes have an unstable relationship with the cues.

In their studies, Hensman and Sadler-Smith (2011) and Lipshitz and Shulimovitz (2007) express favorable opinions of bank loan officers' use of intuition in making credit decisions. However, traditionally, intuitive decision making is considered less reliable than deliberate decision making. The argument is that intuitive decision making is more susceptible to personal biases (Kahneman, Slovic, & Tversky, 1982; Tversky & Kahneman, 1974).

Bank loan research has also focused on the standard lending practices banks use to evaluate loan applicants. Two such practices are relationship lending and transactional lending. Relationship lending focuses on the personal relationship between the loan officer and the loan applicant. Bank loan officers who use relationship lending base their credit decisions on information that cannot be easily quantified, such as impressions from personal contact with the loan applicant and other information not found in financial records (Boot, 2000). Relationship lending requires that loan officers have a close relationship with loan applicants as well as an understanding of their business context (Berger & Udell, 2002). Bank loan officers who are more oriented towards a transactional lending practice, on the other hand, base their decisions on quantitative information, such as cash flows, annual reports, and liquidity measures (Berger & Udell, 2006). Furthermore, transactional lending often requires that loan officers use computerized assistance in making decisions (Thomas, 2000).

Economic research has shown that the use of these two lending practices can be highly influential in assessing the creditworthiness of loan applicants. However, the results of this influence are not clear (Trönnberg & Hemlin, 2012). Some studies show that transactional lending leads to risk-taking but only if the credit-scoring system used is decisive and not advisory (Berger, Frame, & Miller 2005). Others show that relationship lending in general leads to higher risk-taking (Degryse & van Cayseele, 2000; Jiménez & Saurina, 2004) and greater costs associated with approved loans (Hernández-Cánovas & Martínez-Solano, 2010). To our knowledge, however, this research, which suggests that both lending practices are risky, was conducted using only high-level data from summary statistics (e.g., approved loans versus unapproved loans in banks for certain time periods). Therefore, these findings are not necessarily generalizable at the individual level (i.e., at the level of loan officers). Thus, it remains an open question as to how lending technology affect lending decision making.

1.1. Aims

This paper explores how bank loan officers make difficult lending decisions on loan applications by SMEs. The aim of the paper is to investigate how loan officers perceive that they make decisions using the critical incident technique which is not previously done. In contrast to interview studies in this field that relied on small samples and a restricted focus of the decision making process, we can explore in detail a large proportion of the most recent and important decisions that loan officers' recall. This methodology is proven reliable for sampling important behaviors in a number of domains (Ericsson & Simon, 1980; Flanagan, 1954; White, 1980). Results will also be relevant for banks to validate and improve procedures for loans to SMEs. A second aim is to examine the situational and organizational factors that influence bank loan officers' decision making. Situational factors refer to the characteristics of the transaction and the lender—borrower relationship. Organizational factors refer to bank-specific characteristics such as policies and rules.

2. Method

2.1. Participants

We interviewed 88 loan officers at the four largest banks in Sweden (21 at Bank A, 28 at Bank B, 18 at Bank C, and 21 at

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