

SME Finance – The Missing Piece

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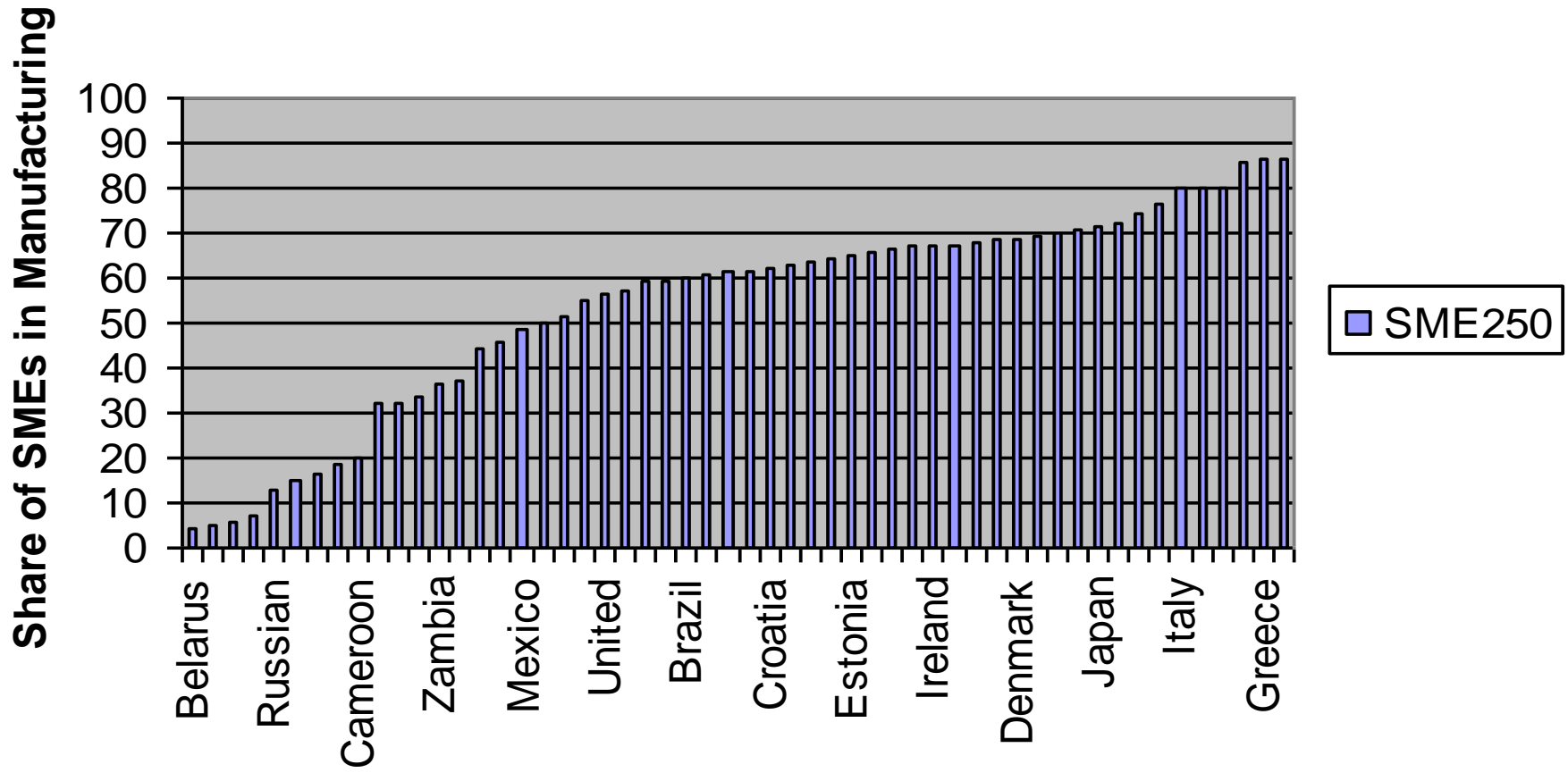


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Do SMEs matter?

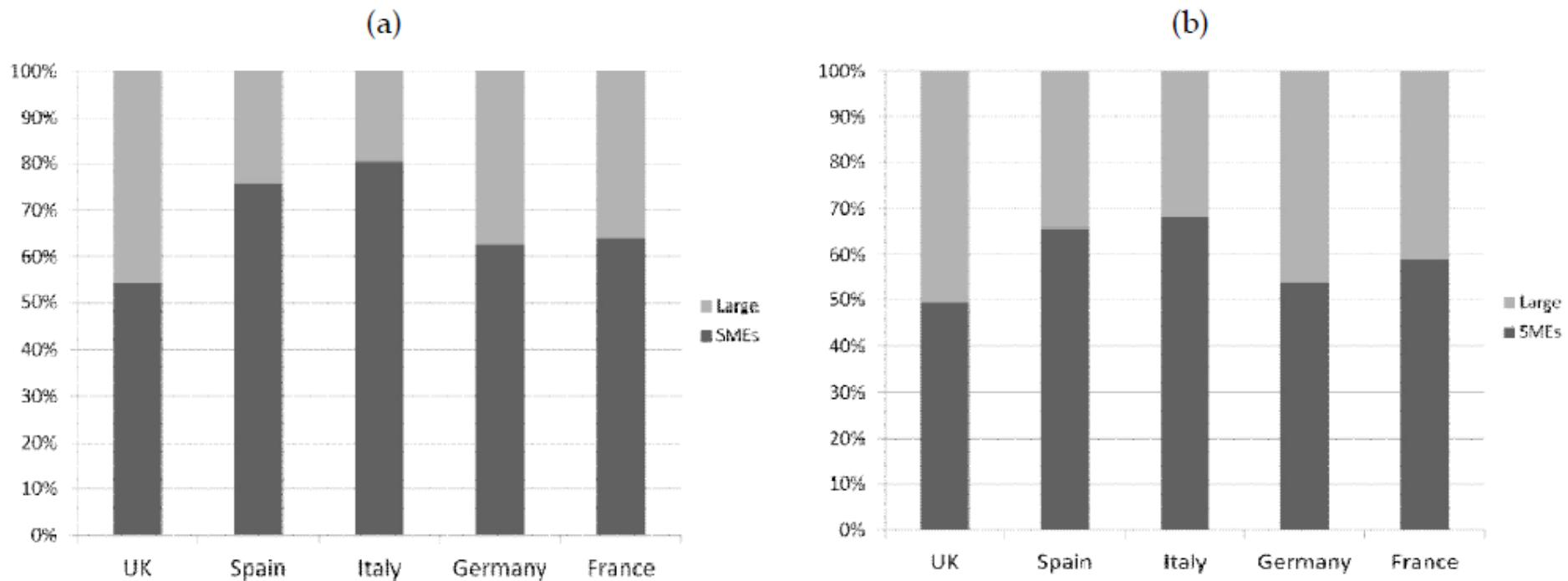
Share of SMEs across Countries



Source: Ayyagari, Beck and Demirguc-Kunt (2007)

Importance of SMEs – in Europe

Figure 1. Employment (a) and value added (b) by country, 2011 (% of total)



Data challenges

- Capturing SMEs
 - Statistical offices, enterprise registers – limitations
 - Enterprise surveys – representativeness, panel better than repeated cross-section
 - Control for survivor bias
 - Informal enterprises?
- What is an SME?
 - Different segments to be distinguished
 - Microenterprises: informal, household- or family based, corner shops
 - Small enterprises – formal; often “missing middle”
 - Medium-size enterprises: aspiring, export-oriented etc
 - Differentiation between subsistence and transformational enterprises is critical for
 - Discussion on job creation
 - Interventions and policies for easing financing constraints

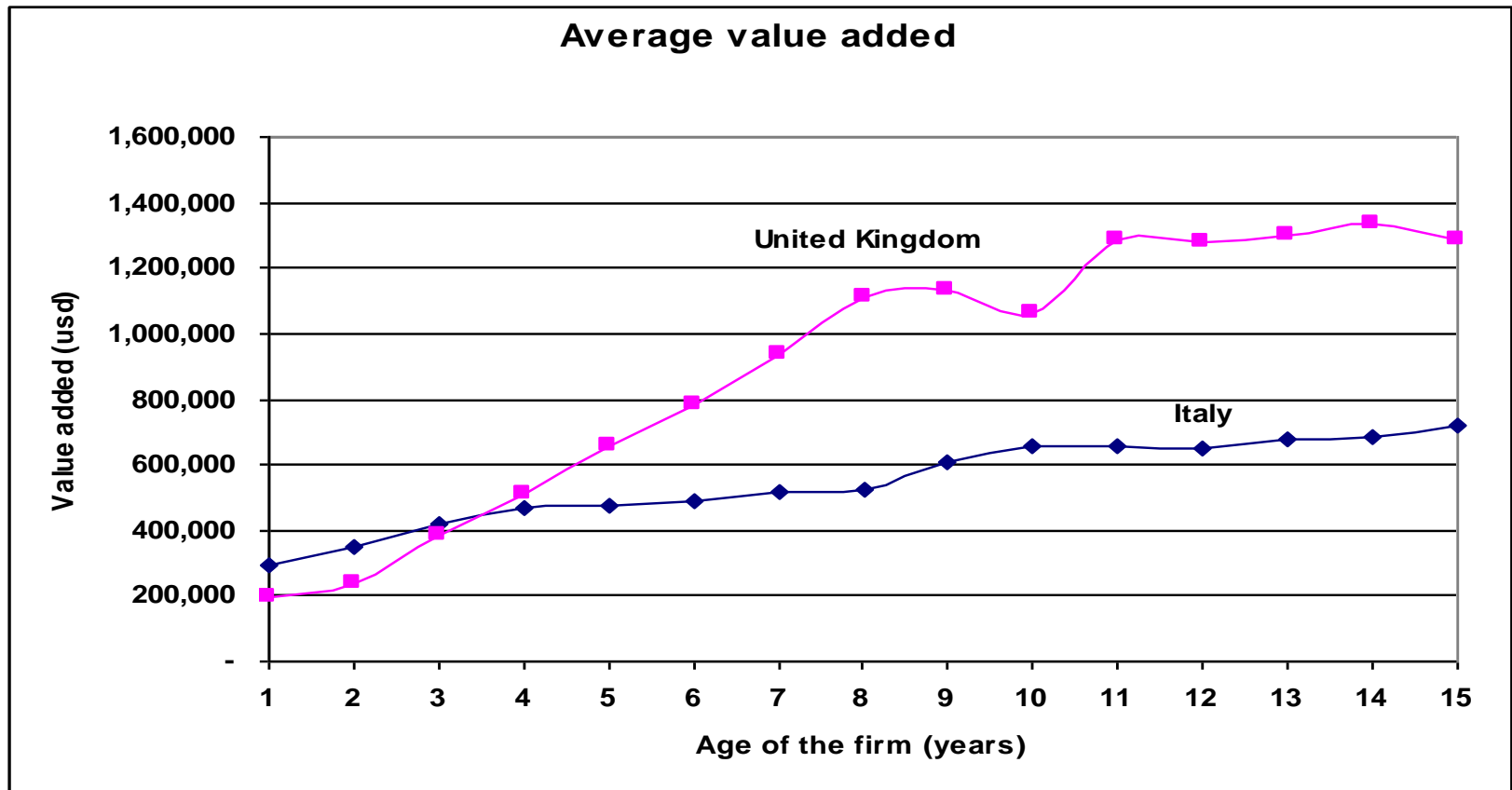
SME Finance-what is different?

- Compared to large enterprises
 - More opaque, less likely to have collateral
 - More reliant on bank finance
 - Typically more financially constrained
- Compared to consumer finance
 - More heterogeneous
- Identifying SME credit gap
 - Distinction between pure and commercially viable demand
 - Firm size distribution is endogenous to financial development

Do SMEs cause growth?

- Although there is a positive and strong association between SMEs and growth in GDP per capita, this is a correlation, not a causal relationship
- A large SME sector is a characteristic of fast-growing economies but not a cause of their rapid growth
- SMEs may face greater growth obstacles, e.g. difficulty accessing external finance.
- A larger SME sector does not necessarily indicate a dynamic SME sector, but rather may be reflection of poor business environment where firms cannot grow
- In some environments it may be optimal to remain small.
- We care about new entry and growth potential of SMEs!

SMEs, entry and exit of firms



Source: Klapper, Laeven and Rajan (2006)

Why are SMEs left out?

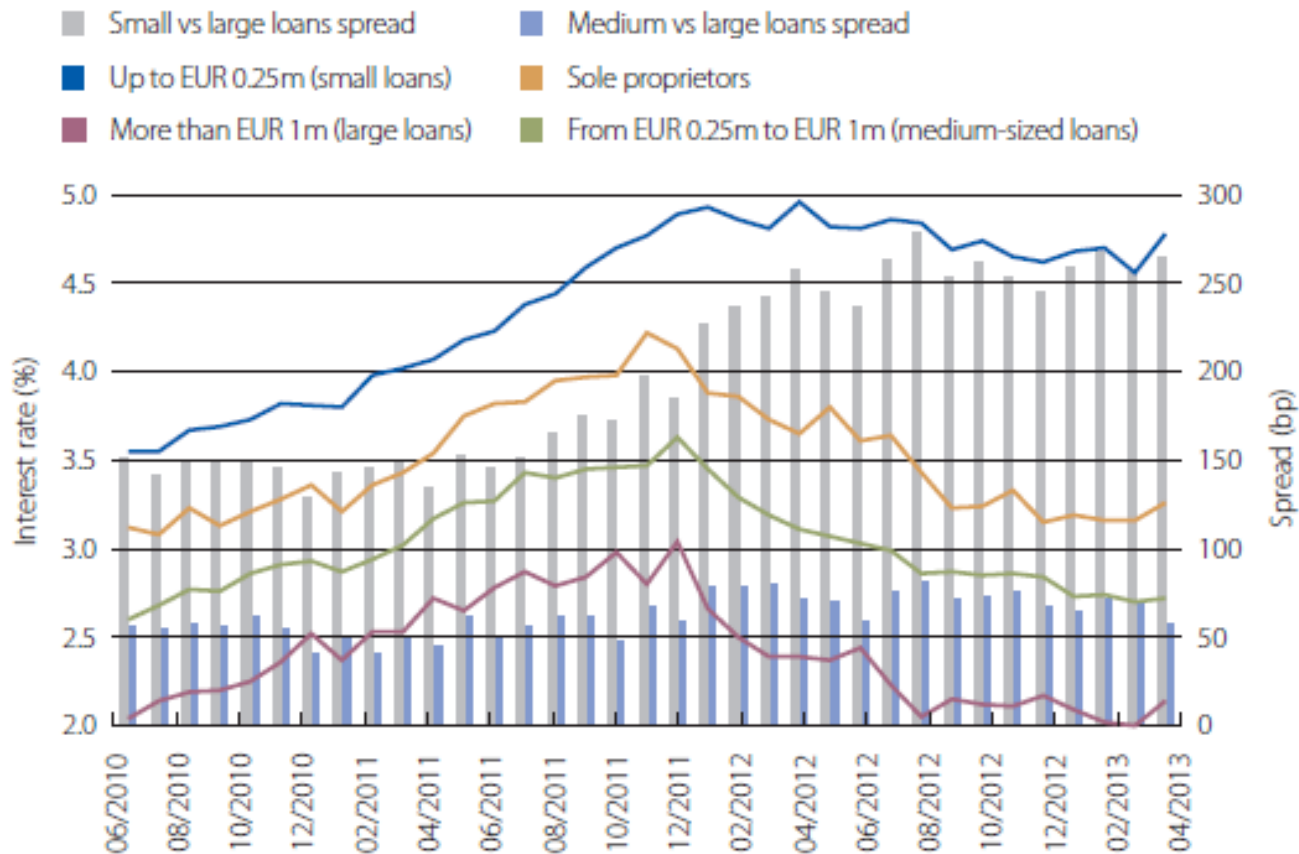
- Transaction costs
 - Fixed cost component of credit provision effectively impedes outreach to “smaller” and costlier clients
 - Inability of financial institutions to exploit scale economies
- Principal-agent problems
 - Related to asymmetric information
 - Adverse selection: High risk borrowers are the ones most likely to look for external finance
 - Increases in the risk premium raise the risk of the pool of interested borrowers
 - Lenders will use non-price criteria to screen debtors/projects
 - Moral hazard: The agent (borrower) has incentives that are inconsistent with the principal’s (lender) interests
 - Agents may divert resources to riskier activities, loot assets, etc.

SME Finance during the crisis

- Might suffer more given risk profile and cost factors
- In addition: regulatory pressures to deleverage
- BUT: continuous relationships might mitigate impact
- Alternative financing sources
 - Crowd-funding
 - Peer-to-peer lending
 - Government lending?

Firm size gap in financing widens during crisis

Figure 3 Evolution of monetary financial institutions' interest rates on new loans to non-financial corporations⁹



SME finance - business models

✚ The conventional view

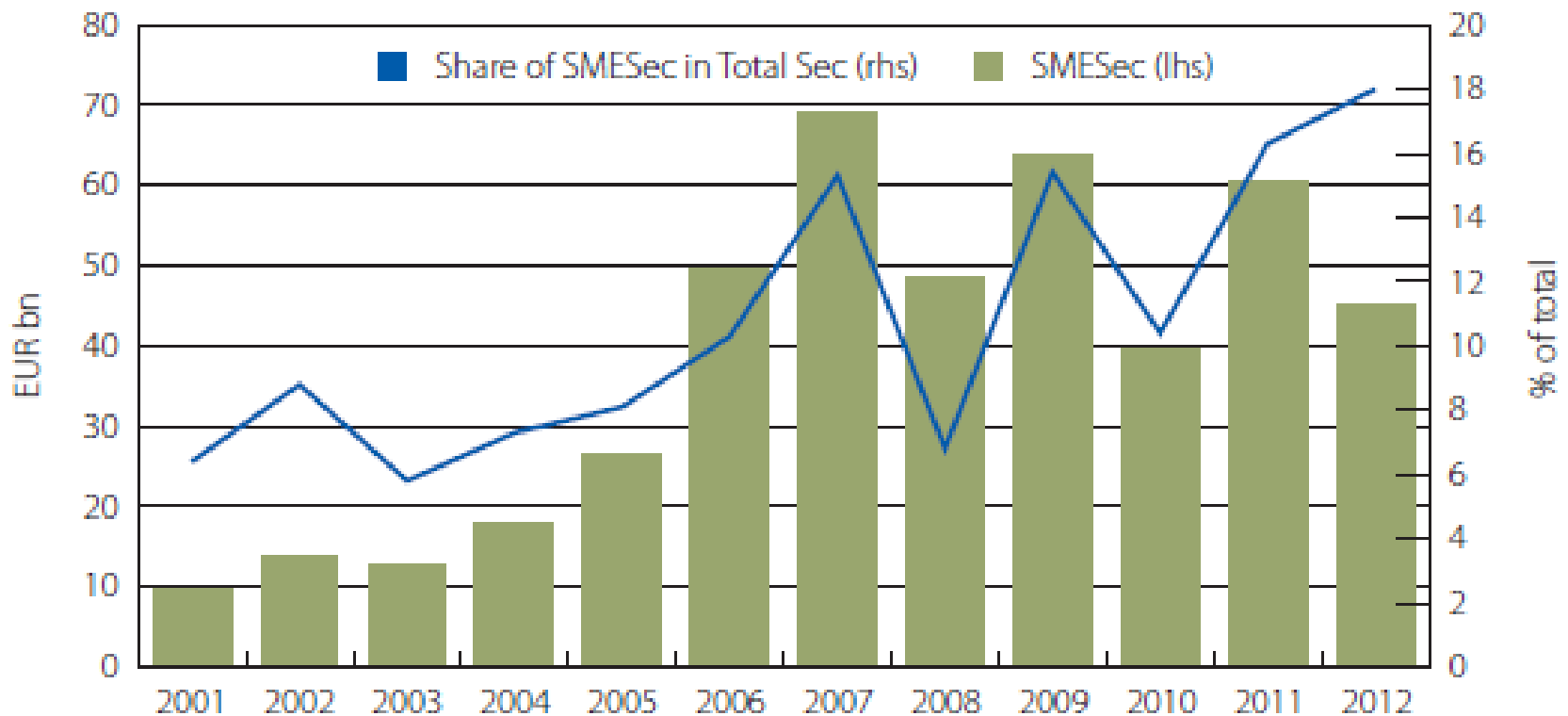
1. SMEs are opaque. Have unknown capacity and willingness to pay.
2. SME lending is based on “relationship lending”, which relies on “soft” information gathered by the loan officer through direct and repeated contact with the firm.
3. Large and foreign banks are not interested or have a disadvantage in SME lending because they rely on arms length financing technologies.

✚ New paradigm on SME finance

- ✚ Large and foreign banks can have a comparative advantage at serving SMEs through different arms length technologies (asset-based lending, credit scoring, factoring, leasing, etc.)

Loan securitization

- Limited, given heterogeneous nature of SMEs
- Further depressed during crisis, new rules etc.



Access to credit: the role of government

- Beyond improving “state” variables
- Focusing on contestability of financial markets
 - Low entry barriers
 - Infrastructure open to all financial institutions
 - No regulatory barriers to innovation
- Pro-market activism
 - Do not replace markets, but help overcome market failures
 - Well-designed, limited (time, resources etc.) interventions might help
 - Demonstration effect for private sector
 - Trial and error, no one size fits all
 - Partial credit guarantee schemes
 - Additionality vs. sustainability – devil is in detail

Regulatory policies

- Provisioning and capital requirements capturing riskiness of lending to large corporates vs. SMEs
- Provisioning requirements based on hard collateral
- Taxation issues related to leasing

Partial credit guarantee schemes

- Idea: overcome agency problems between lender and borrowers
- Sustainability vs. additionality
- Devil is in the detail
- Few rigorous assessments: Chile, France

Equity funds

- Seems a good idea for mid-sized firms that do not have scale or track record to tap public equity or debt markets
- Large literature on the effect of equity funds on firm-level outcomes for the U.S.
- Limited evidence for rest of the world
 - Limited data points
 - Challenge: construct control group
- Along similar lines: venture capital funds
- Mixed financing structures (mezzanine finance, hybrid forms)

Look at demand-side constraints

- Financial literacy
 - Financial awareness of products and options
 - Financial capability
- Accounting and auditing standards
- Business development services – turn investment into bankable projects
- Don't ignore non-financial constraints

What have we learned?

- Although SMEs do not cause economic development, they are a crucial part of the private sector and suffer more from market and institutional failures
- In order to understand access problem, consider different constraints and resulting policies
- Technology, innovation and private credit provision are central to improving SMEs' access to credit
- Different providers have important roles to play (different bank types, NBFIs, MFIs, equity funds etc.). One size does not fit all!
- Government has role to play, both in developing and enabling markets
- Demand-side constraints should not be ignored!

What do we need to learn?

- More focus on entrepreneurship (supply and demand-side constraints)
- More data on enterprises and their financing (needs)
 - Panel data set
 - Complement with bank-level surveys
- Impact evaluation of reform policies
- More focus on demand-side constraints

What's next for policy

- Need for diverse and competitive financial system
- Given bank-based nature of Europe financial systems, banking crisis has to be addresses
 - NOW, before banking union!
- Need more and better data to understand SME segment
- Focus on transformational enterprises, not broad subsidy schemes

Thank you

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