

Bank Involvement with SMEs: Beyond Relationship Lending

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The SME Financing Problem

- **Widely believed that SMEs are financially constrained**
 - **Many countries have instituted programs predicated on this assumption**
 - Gov't loan guarantee programs and direct subsidies
 - Both in developed and developing economies: e.g., Chile, Columbia, EU, Japan, US,
 - **Academic literature provides theoretical framework and empirical evidence**
- **Systemic SME financial constraints primarily stem from opacity**
 - **SME opacity causes a *funding gap***

THE SME FIRM CONTINUUM

**Unqualified Borrowers
(should not receive financing)**

**Easily Bankable with
Traditional Financial Statement Lending**



**Lowest
Financial
Strength,
Highest
Opacity**

**Highest
Financial
Strength,
Highest
Transparency**

The Funding Gap Zone

The Funding Gap

- The funding gap = the deficiency in financing for “good” companies who otherwise deserve credit
- Types of firms with a “funding gap”
 - Firms with good business models
 - i.e., positive net present value cash flows
 - Firms with skilled entrepreneurs
 - Some firms with high (and even *very high*) growth potential

BUT, firms with a *funding gap* also tend to be:

- Undercapitalized
 - Entrepreneurs constrained by limited financial resources
- Smaller firms whose “smallness” makes them more opaque
 - Some of these firms may not be able to afford audited financial statements
- More vulnerable to financial shocks

The Funding Gap (cont.)

- **Traditional lending (primarily underwritten based on strong financial ratios) can not solve the funding gap problem because firms in the critical zone tend to be either undercapitalized and/or opaque.**
 - That is, there is credit rationing because of the funding gap.
 - Gap is likely greater in developing economies with weaker information environment
 - Gap could worsen under idiosyncratic firm level shocks or system-wide macro shocks.
- **Research on SME funding has focused on how financial markets have attempted to mitigate the funding gap.**

CONVENTIONAL WISDOM

- **Literature has tended to emphasize relationship lending as the primary solution to the funding gap**

Because small banks better at producing soft information due to organizational diseconomies:

- **Smaller banks are better suited to fund opaque SMEs**
- **Large banks and foreign banks ill-suited to funding SMEs**

CONVENTIONAL WISDOM (cont.)

- **And, transactions based lending is only well suited for the “best” SMEs**
 - Emphasizes informative financial statements
 - Cannot solve the funding gap
- **So, large banks and foreign banks limited to financing large firms and the most transparent of SMEs**
- **Relationship lending particularly important because information environment is acutely weak**
- **Even in developed economies relationship lending important**
 - Banking consolidation could eliminate community banks
 - 2 Fed conferences recently on this topic

LENDING TECHNOLOGIES: A “NEW” PARADIGM

- The implications of the old paradigm are misleading.
- The “new” paradigm emphasizes lending technologies (Berger and Udell 2006)
 - Definition: a unique combination of primary information source, screening and underwriting policies/procedures, loan contract structure, and monitoring strategies/mechanisms
- There are a number of very different transactions lending technologies based on hard information.
- Most of these other transactions technologies are well-suited to opaque borrowers
 - Financial statement lending is the only exception
- Thus, large banks and foreign banks can lend to opaque borrowers using these transactions technologies

Lending Technologies

TECHNOLOGY	TYPE	BORROWER	INFORMATION
Relationship Lending	Relationship	Opaque	Soft
Financial Statement Lending	Transaction	Transparent	Hard
Asset-Based Lending	Transaction	Opaque	Hard
Factoring	Transaction	Opaque	Hard
Leasing	Transaction	Opaque and Transparent	Hard
Small Bus. Credit Scoring	Transaction	Opaque	Hard
Equipment Lending	Transaction	Opaque and Transparent	Hard
Real Estate-Based Lending	Transaction	Opaque and Transparent	Hard
Trade Credit	Transaction	Opaque and Transparent	Soft and Hard

LENDING TECHNOLOGIES AND DEVELOPING ECONOMIES

- The feasibility and efficacy of each lending technology in a specific country will depend on:
 - a country's financial institutions structure
 - a country's lending infrastructure
- Some lending technologies may not be powerful (or even exist) in countries with poor structures
 - e.g., asset-based lending only in 5 common law countries
- Other lending technologies may be more important in countries with poor structures
 - e.g., factoring and leasing (ideal in countries with weak bankruptcy systems)
- KEY POLICY IMPLICATION: Large banks can provide credit to opaque SMEs even in informationally challenged developing economies

THE PROBLEM

- **This defies conventional wisdom**
- **Has not been tested empirically**
 - **Mostly just anecdotal evidence, or**
 - **Case by case (technology by technology basis)**
- **This paper is by far the most important empirical test of this new paradigm**

THIS PAPER'S CONTRIBUTION

- **Investigates in developing economy setting**
 - Role of large banks in SME financing
 - Whether SME financing limited to relationship lending
- **Main Findings**
 - SMEs are a strategic target for most banks including large and foreign-owned
 - Confirms that relationship lending is not the only SME lending technology used in developing economies
 - SME lending part of package of services

FUTURE RESEARCH

- **How important is relationship lending in developing economies?**
 - Are small banks irrelevant?
- **Is relationship lending a substitute or a compliment?**
 - Can relationships “boost” transactions lending
- **Developed economies have longest menu (e.g., UK and US)**
 - Is this the optimal? For developed economies?
 - Which borrowers use which technologies?
 - These technologies tend to be delivered in organizationally separate platforms.
 - ABL in U.S.
 - Factoring in Japan
 - Is this optimal?

FUTURE RESEARCH (cont.)

- **What explains the big differences in SME lending across countries?**
- **What is the optimal investment in information infrastructure and the optimal legal/regulatory policy?**
 - **China's new laws on A/R**
 - **Japan's new laws on moveable assets**
 - **Vietnam's new factoring laws**
 - **Much we don't know, e.g.,**
 - **Big change in U.S. in asset appraising and liquidation infrastructure**
 - **Should we look to innovations in developed countries as templates**
 - **What about cross border initiatives, e.g., UNCITRAL**

FUTURE RESEARCH (cont.)

- **How important is trade credit?**
 - Is it a separate lending technology?
 - Is it a substitute or a compliment?
- **What happens to SMEs after financial shocks?**
 - Firm level shocks
 - Macro shocks
 - Do some lending technologies become more important, others less?
 - Lending channels
 - Does trade credit play a special role?
 - Do foreign banks play a special role?
 - Do state-owned banks play a special role?

FUTURE RESEARCH (cont.)

- **Paper suggests that economies of scale may give advantage to large banks in transactions lending**
 - **Consistent with theory (Stein 2002)**
 - **Not particularly consistent with (general) empirical work on banking**
 - **Not consistent with some new evidence in developed economies (Japan – Uchida, Udell and Yamori 2007)**
 - **Also inconsistent with U.S. anecdotal evidence**
 - **Outscore credit scoring data (FICO)**
 - **ABL software**