

World Bank

Conference on Small Business Finance: What Works, What Doesn't?

Washington DC, May 5-6, 2008

Comments on

“Banking SMEs around the world:

Lending practices, business models, drivers and obstacles”

by T. Beck, A. Demirgüç-Kunt and M.S. Martínez-Peria

By

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My comments

- Relevance of the paper
- Critical assessment of findings, particularly:
Can the results be reconciled with
conventional wisdom on the subject?

Contributions of the paper

- Impressive new micro-level survey
 - **45 countries** (38 developing and 7 developed)
 - **91 large banks** (80 from developing and 11 from developed countries)
 - **56 questions** covering most relevant aspects of SME loan policies
- Valuable contribution to the literature on SME finance
 - Badly needed look at formal credit suppliers (banks)
 - Approaches the problem with a magnifier by focusing on large banks and distinguishing small vs. medium firms and developing vs. developed countries

Findings and questions

SMEs vs. Large Firms

B-DK-MP 2008	Conventional Wisdom
Similar share of total loans	Smaller
Similar and very high share of loan applications approved	Smaller
Similar share of secured loans	Larger (or lower in relationship lending)
Similar loan fees	Higher
Similar (and low) interest rates	(Much) Higher

Conclusion: SMEs have much easier access than usually believed

Developing vs. Developed Firms

B-DK-MP 2008	Conventional Wisdom
Similar share of total loans to SMEs	Smaller
Larger share of secured loans in developing countries	Larger (but could be lower due to defective legal and enforcement framework)
Larger loan fees in developing countries	Larger
Higher interest rates in developing countries	Higher
Similar share of non-performing loans in developing countries	Higher

Conclusion: Worse lending conditions in developing countries, but differences not as wide as expected

Ultimate Question: Who's Right?

Assumptions in Conventional Wisdom about SMEs:

- Opacity
- No credit track record
- Lack of hard capital (tangibility)
- Vulnerability to economic shocks (high probability of default)

Possible Biases in the Sample I

- SME definition: Up to \$14.5 million in developing countries and \$28 million in developed countries
→ may include rather large, mature firms with acceptable accounting systems relatively immune to asymmetric information
- Do these SME borrowers operate in the formal or the underground economy?
- How different are lending conditions for small vs. medium enterprises?

Possible Biases in the Sample II

- High collateral (49% in developed and 81% in developing countries) → But has the typical SME enough capital to pledge as collateral?
- Large banks may mostly target good ex ante risks and more transparent firms among all SMEs:
 - Clients, suppliers or related companies of their large clients [more frequent in developing countries]
 - Good borrowers drawn from credit bureau databases (informational cascade) [more frequent in developed countries]
- Self-selection (reflected in low rate of applications turned down), especially when approaching big banks

Possible Biases in the Sample III

- Are some of these large banks government-owned banks with pro-SME policies?
 - Government subsidies to SME loans? Interest rate subsidies, guarantee schemes, and direct credit in place in 38 countries
- *Direct or indirect pro-SME intervention in credit markets may also explain good lending conditions to these firms*

Criteria for approving loans to SMEs

- Competition is cited as a major obstacle by 45% of banks in developed countries and 15% in developing countries
 - But isn't relationship lending grounded on monopolistic rents for the bank/s involved?
 - With how many banks SMEs in the sample operate?
- 6% of banks in developing countries cite opacity and informality as obstacles
 - But shouldn't this be *the* main obstacle for the typical SME?

Factors affecting SME financing

- Financial assessment is the most important criteria for about 50% in both country groups
- Credit history with the bank (16%) and owner characteristics (9%) follow
- Collateral is third with 8%

In **relationship lending**, credit history and owner characteristics should be most important

Financial records, due to unreliable or inexistent accounting statements and business plans, should be less relevant for the median SME

→ *Are we dealing with the median SME?*

Additional questions

- Too low average interest rate on SME loans and narrow difference between best and worst clients?

Developing countries: [11.16%; 15.65%]

Developed countries: [4.66%; 8.79%]

- Are these real or nominal interest rates?
- Why about 80% of banks require collateral but less than 10% consider collateral as the most important criteria for granting a loan? Common issue to all firm sizes and country groups
- Size and purpose of the loan as criteria for approving a loan? Size is endogenous and money is fungible.

FELABAN Survey (2007)

85 small, medium, and large banks in Latin America
asked about SME credit policy

Issue	Small Banks	Medium Banks	Large Banks
Has a specialized SME department?	71	86	100
Bank representatives always visit potential borrowers?	25	47	67
Use of credit scoring	14	23	44
Lack of transparency as a major obstacle	35	47	50
High administrative costs as a major obstacle	44	33	25

Lessons

- SMEs are a heterogeneous set of companies and it would be advisable to avoid stereotyping
- We should move from a size-based definition to an information-based definition (quality and certification of accounting statements, tax compliance, years of participation in formal financial markets, and so on)
- The same applies to banks: target clientele and lending policies vary according to size and ownership
- Joint consideration of supply and demand are needed for an accurate identification of financing problems

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