SMEs' Access to Finance: Is there still a debt finance gap?

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Abstract

There is evidence that some SMEs may still face difficulties in accessing bank finance from lenders (CEEDR, 2007). This paper reports an in-depth study into demand and supply side issues relating to access to bank finance by Scottish SMEs and whether there is still market failure associated with good, bankable business cases from SMEs that do not receive finance. We argue that our study utilises innovative methodology and is relatively rare as a robust study in this area. We combine demand side in depth survey analysis of SMEs with supply side analysis by bank managers of real business propositions through verbal protocol analysis.

This paper discusses the ability of SMEs to access debt finance from the commercial banks in Scotland, it reports findings from a survey of 51 SMEs that had reported having difficulty raising finance and from interviews with bank managers utilising verbal protocol analysis with validated real SME business proposals to give insights into the decision-making of bank managers in the processing of proposals from SMEs. Theoretically, there are categories of SMEs that may face greater difficulties or contain circumstances in which it is more difficult for bank managers to apply standard decision-making models and these categories are explored to provide a theoretical framework for the investigation. The theoretical framework provides themes for discussion of the findings. These include for example; younger SMEs and owners, rural-based SMEs and manufacturing SMEs. Bank officers were found to follow standard financial models, although considerable discretion could be exercised by senior bank managers often leading to a heavy reliance on personal relationships. Smaller and newer SMEs where discretion was more limited were more likely to face difficulties. The study revealed a number of categories of SMEs that face difficulties, including strong growth SMEs in rural environments, new and young SMES, young entrepreneurs seeking start-up finance and manufacturing SMEs seeking to diversify and finance new product development.

Focusing on these categories of SMEs,we analyse survey evidence, in depth case studies and verbal protocol analysis with bank managers to discuss research questions on whether informational effects can lead to market failure in the provision of debt finance, the circumstances in which sound propositions are turned down and whether such circumstances can be prevented. This forms the basis for development of conclusions on the continued existence of a debt gap for certain categories of SMEs and some policy implications.

Keywords: bank finance, debt gaps, verbal protocol analysis, financial modelling.

Introduction

Since the termination by the Bank of England of its annual reports on the finance of small firms (Bank of England, 2004), with the assumption that there is no market failure in the provision of debt finance, there has been little attention given to SMEs' access to debt finance. The advent of computer-based systems of decision-making in the commercial banks, such as credit-scoring and financial modelling, has also given weight to the view that individual owners of SMEs should not be disadvantaged by any particular characteristic (gender, race, age, sector, new and fast growth) in seeking access to bank finance. The focus of policy has been on SMEs' access to small amounts of equity finance through the stimulation of the informal and formal venture finance market. Examples of such initiatives include the Regional Development Agencies' (RDAs) Venture Capital Funds in England and the Co-investment Fund of Scottish Enterprise in Scotland. This paper discusses the ability of SMEs to access debt finance from the commercial banks in Scotland, it reports findings from a survey of 51 SMEs that had reported having difficulty raising finance and from interviews with bank managers utilising verbal protocol analysis with validated real SME business proposals to give insights into the decision-making of bank managers in the processing of proposals from SMEs. Theoretically, there are categories of SMEs that may face greater difficulties or contain circumstances in which it is more difficult for bank managers to apply standard decision-making models and these categories are explored to provide a theoretical framework for the investigation. The framework also provides themes for discussion of the findings, including for example; younger SMEs and owners, rural-based SMEs and manufacturing SMEs.

The investigation of SMEs' access to finance was undertaken for the Scottish Government during the summer of 2007 (Scottish Government, 2008). The research was commissioned to investigate further the difficulties that a significant minority of Scottish SMEs that took part in the Annual Small Business Survey (ASBS) (Scotland) reported in accessing finance from banks. The research was prompted by results from the 2005 ASBS survey which showed that, out of the 1002 SMEs that took part in the survey, 11 per cent of them sought finance in the 12 months prior to the survey and just under a quarter of these reported experiencing problems accessing finance. The paper reports the findings from the in-depth investigation of the issues reported by SMEs and the decision-making of bank managers. The paper is organised on the following lines: the next section outlines the theoretical framework, followed by relevant literature and methodology before discussing the findings. The paper concludes with some policy implications.

Theoretical Framework

There has been a theoretical debate for some time in the academic literature about the nature and existence of potential market failure with SMEs' access to bank and debt finance. This debate focuses on two aspects of bank lending to SMEs; on whether credit availability to SMEs is affected by the existence of informational asymmetries and on whether this is affected by reputational effects.

Informational asymmetries considered under a basic theoretical analysis of conditions of imperfect information suggests that there will be insufficient credit available for all sound or 'bankable' propositions (Stiglitz and Weiss, 1981). Asymmetric information means that there will be some proposals on which bank officers will not have 'perfect' information. These, for example, include new and technology-based propositions for which market intelligence will be limited and asymmetric information is more acute. At an early stage, information is limited and not always transparent (Hall et al, 2000; Schmid, 2001) and assets are often knowledge based exclusively associated with the founding entrepreneur (Hsu, 2004). Especially with manufacturing or technology based firms, entrepreneurs may be reluctant to provide full information about the opportunity because of concerns that disclosure may make it easier for others to exploit (Shane and Cable, 2002). There are also some categories of owners of SMEs that will face additional problems due to lack of security, such as young entrepreneurs or those from deprived areas. In addition, there may be asymmetries arising from location as well as sector. For example, owners of SMEs in rural environments may face difficulties with access to bank finance (OECD, 2008).

Reputational effects apply theoretically where SME owners are prevented by their own or others experiences from applying for debt finance. This provides a discouraged borrower effect (Kon and Storey, 2003; Fraser, 2005). That is, some small business owners may not access finance because at some stage they are discouraged from applying. For example, ethnic minority or women owners, who may be discouraged by perceived bureaucracy or financial requirements or are discouraged by a first refusal (Deakins, et al, 2005). Entrepreneurs may not seek finance if there are perceived issues. This could be either that they think they will be unsuccessful so there is little point in applying or a perception that they will not have the information and good credit history that it is perceived that banks require. It may occur where entrepreneurs from certain groups distrust bankers, as for example can occur with ethnic minority entrepreneurs since they may perceive institutional bias in banking institutions. Other work has suggested that women seeking to start-up businesses may also form a category of discouraged borrowers (Roper and Scott, 2007). The extent of any discouraged borrower effect is unknown, but it may be important amongst ethnic immigrant groups. It has been suggested that banks with extensive and close relationships with some small firm communities may be able to overcome these adverse effects (Watanabe, 2005).

Despite the development by the banks of more sophisticated decision-making and financial modelling approaches, supported by increased market intelligence and developments in relationship banking that may help to over come these informational and reputational effects, theoretical arguments suggest that there are, nevertheless, a number of categories of SME owners that could be affected by informational issues or reputational effects. These include the following categories:

- Younger SMEs and younger entrepreneurs with limited trading records and security
- Female and ethnic minority entrepreneurs (from reputational effects).
- Fast growth firms especially in manufacturing and technology-related sectors.
- Out of the 'norm' situations where SMEs owners have unusual business propositions; such as high growth proposals from SME owners in rural environments.

This theoretical framework leads to the following research questions:

RQ1: Whether reputational and informational effects can lead to market failure in the provision of debt finance.
RQ2: If market failure exists, what are the circumstances in which sound propositions are turned down?
RQ3: Whether such circumstances can be prevented

To investigate these research questions requires innovative research techniques, these are explained in the research methods section of the paper; first, we give a brief review of the relevant literature and previous research evidence.

Relevant Literature and Previous Research Evidence

Previous studies have focused on whether SMEs face difficulties in accessing finance, which can be determined as demand side studies, and issues in bank lending practices, which can be determined as supply side studies.

The demand side studies suggest that; whilst overall the majority of SMEs appear not to have difficulties obtaining external finance, there is evidence to indicate that a number of groups and sectors do face distinct challenges in accessing finance. Existing research evidence indicates that dissatisfaction with the availability of loan finance and overdraft finance from banks is greatest among the youngest and smallest firms (FSB, 2002). The most recent FSB biennial survey indicates that the youngest businesses (1–3 years) are less likely to use bank overdraft and retained profits and more likely to use own savings, family, personal credit card and second mortgage. Youngest businesses (less than three years old) were least likely to have their application approved (FSB, 2006, p. 43).

High levels of dissatisfaction with bank finance have also been found amongst women entrepreneurs (Fielden et al, 2003), which may reflect the fact that they do not necessarily fit the normal business owner stereotypes of bank lending managers and that they invariably run low tech enterprises in the personal service sectors. Compared to men, women perceive risks differently and are less inclined to use their own house as collateral (Wilson, 2007).

There is also evidence to indicate that Black and Minority Ethnic Businesses (BMEBs) are more likely to experience difficulties in accessing external finance than non-BMEBs, and particularly those from the Afro-Caribbean community (British Bankers Association, 2002; Small Business Survey, 2006). In Scotland, research has shown a marked reluctance amongst Scottish BMEBs to approach or attempt to use bank finance, even amongst second generation owners (Deakins et al, 2005). This has been confirmed in a recent study by Irwin and Scott (2007) who undertook a survey of 400 SMEs and found that 16% reported difficulty accessing finance, but the highest categories reporting difficulties were amongst young and black entrepreneurs.

Some demand-side research with young entrepreneurs has confirmed that market failure probably exists due to the limited security and personal assets of younger SME owners. For example, an evaluation of the PSYBT scheme in Scotland, concluded that; "whilst it cannot be assumed that there is direct evidence of market failure, the survey findings suggest that the clients faced difficulty in securing finance from traditional sources such as banks." (unpublished report for Scottish Enterprise, p 73).

There is some evidence to suggest that some SMEs in rural environments may face additional difficulties. This has been reported for Scotland by the OECD when collecting evidence for their review of rural policy (OECD, 2008). Recent unpublished research for Scottish Enterprise suggested that fast growth firms find it easier to raise finance in the Central Belt (Glancey and Greig, 2008). It is suggested that these difficulties can arise with high growth or manufacturing SMEs in rural areas (OECD, 2008), since bankers are not familiar with high growth proposals. Although there are wealthy individuals in rural areas, the evidence in Scotland suggests that they prefer to invest in the main metropolitan areas, especially Edinburgh and Glasgow (Glancey and Greig, 2008)

The perception of a finance gap may reduce the willingness of SMEs to approach the banking network to secure appropriate financing. A report for the Small Business Service (SBS) (Allinson, 2005 p.3) commented: "if people do not present themselves to a financial institution in the first place, because of self-selection and possibly underpinned by belief in a myth, then it may appear that the institutions' rates of granting loans are quite high – that they are meeting demand." This can lead to businesses seeking to 'bootstrap' rather than securing more appropriate financial packages. Typically these businesses become dependent on financial support from their own resources and family and friends. "But that leaves a problem for anyone with a viable proposition but without family and friends without any resources to help" (Irwin and Scott 2005 p.6). This scenario is a key issue for some businesses at the start-up phase. Fraser (2005) for example, found that obtaining finance is a major problem at start-up for 10 per cent of businesses: 11 per cent of businesses needing new finance experienced outright rejection; 19 per cent received less than they wanted; and 8 per cent felt discouraged from applying because they expected to be rejected. As Irwin and Scott (2005 p.7) comment: "These figures of course, disguise two problems – the businesses for whatever reason, are unable to raise finance and, perhaps more importantly, those prospective businesses that never actually start because they are unable to raise the finance."

Supply side studies, especially on bank finance compared to studies into other forms of SMEs' finance are relatively rare. This is partly because of access issues and the sensitive and competitive nature of the banking sector, where obtaining information on lending practices may breach business confidentiality. One study by Lean and Tucker (2000) found that financial providers had a lack of knowledge about the nature of the client's business on the one hand, and that many business owners had a lack of knowledge about the lending criteria and procedures of the banks on the other. This study also suggested that trends in the banking sector such as market concentration and centralisation have compounded the problem of information asymmetry.

There is some evidence that accessing finance may be affected by differences in supply side practices and policies i.e. in commercial banking policy (BBA, 2002), insofar as they affect the perceptions and attitudes of small business owners seeking to raise finance. For example, commercial banks differ in the extent to which relationship banking is applied to the small firms sector, with some differences in the extent of centralised decision-making, based on credit-scoring methods but with local relationship bankers working with small firm clients, compared with more localised systems of decision-making.

The extent to which banks work with intermediaries may also affect access to finance for some business owners (Watanabe 2005). For example, this may include referral from agencies or brokers. It is arguable that access to such networks may, in turn, affect access to finance through the ability to call on recommendations (Deakins et al, 2003).

Studies with bank managers that utilised real business proposals are even rarer because of the difficulties in developing real business proposals combined with securing the participation of bank managers that provide information that is commercially sensitive. Mason and Stark (2004) used verbal protocol analysis with three bankers, three venture capital fund managers and four business angels who were asked to examine three outline business proposals (taken from Venture Capital Report and Business Angel Bureau). They found that bankers, compared to VCs and business angels, place greater weight on financial information. A study by Wilson, et al (2006) used one hypothesised business proposition in their research with 35 bank managers who were asked to describe their reactions, the criteria they were considering and their loan decision. The Wilson et al study (2006) focused particularly on credit scoring, highlights the variability between lending officers working for the same clearing bank in the way in which they applied the same credit scoring framework (Wilson et al, 2006). Interestingly, it also showed the importance that was attached to the character of the business owner, compared with other factors such as collateral and capitalisation.

The research evidence generally supports the suggested hypotheses outlined by the theoretical framework. There is some consistent evidence to suggest that some categories of SME business owners have difficulties accessing bank finance and that there may be consequent failure affecting the following categories:

a) First, by personal characteristic of the business owner, age, gender and race; that is, young, female and BMEB business owners.
b) Second, by age of the firm, with younger firms facing greatest difficulties.
c) Third, by sectoral characteristics; that is, manufacturing and new technology firms with growth business proposals.
d) Fourth, by location; that is with business owners in rural and deprived areas.

Research Design and Methods

A research design incorporating a number of linked stages contained a number of innovative features. These included research on the supply as well as the demand for bank finance, the development of in-depth case material, the verification of the case material with an independent banker and finally the use of the case material for interviews with a number of bank managers using the technique of verbal protocol analysis.

The first stage consisted of demand-side analysis of the questions on access to finance in the 2006 ASBS (Scotland) for the 64 firms that indicated problems in accessing business finance. As well as information on various characteristics (e.g. age, sector, growth orientation) of the businesses, this provides some data on the nature of the difficulties that the businesses experienced, the type and amount of finance being sought, and reasons for the difficulties.

A second stage was to investigate the issues in greater depth, a telephone survey of 51 Scottish SME owner/managers was undertaken during July and August 2007, drawn from respondents to both the 2006 and 2005 ASBSs in Scotland who had indicated that they had encountered some form of problem in accessing external finance for their business. These comprise businesses that: (i) obtained no finance; (ii) obtained less finance than they required; or (iii) obtained what they required but with difficulties. Survey data was collected via extended telephone interviews, undertaken with owner/managers of SMEs. The survey probed in order to find out whether the access to bank finance problems encountered were as a result of (i) risk averse bank lending procedures and decisions, as opposed to (ii) poor business proposals and/or the poor financial status of applicants.

The telephone survey also acted as the basis for the third stage which involved a selection of a small number of test cases of firms that, *prima facia*, appeared to have put forward a strong business case for bank finance. These cases provided instances of where a seemingly good business proposition had been rejected for loan/debt finance or where the failure to obtain external finance had seriously curtailed the growth of the business.

The fourth stage involved the development of seven case scenarios which were selected and presented to an independent bank lending expert for analysis and verification. As a result of this verification stage, five cases were selected that were suitable for the verbal protocol analysis that was to be used in the interviews with current bank lending officers. Five case studies of firms whose applications for finance were rejected were eventually selected for analysis by the participating bank managers. These five cases, after verification from the independent banker, provided a varied range of scenarios size of business, turnover and credit requirements. Eight bank managers from the three participating commercial banks took part in this stage of the research. They all received the case studies in advance of the interview together with the interview structure. All banks segment the SME business market, generally on the basis of the size of the business, which resulted in the division of cases for one of the participating banks between the bank managers. Extensive pre-interview work and time was, therefore, completed by each of the eight bank managers and all interviews were conducted face to face by members of the research team, each interview taking up to two hours.

The final fifth stage involved asking the interviewed bank managers to think through their decision-making processes using the information provided for the individual case studies. Verbal protocol analysis is a proven social research technique where the subject of the research is managerial decision-making. In this study, there was a need to obtain information on the 'protocols' that decision-makers use when making decisions. The technique involves using real scenarios or real cases, or if hypothetical scenarios ones that are as close as possible to real cases, which are then used to ask managers to talk through their decision-making process. As such, the technique is deliberately open-ended and to some extent dependent on the skill of the researcher, as well as on the quality of the real cases. Better analysis can be obtained if a variety of real cases is provided (Ericsson and Simon, 1993). In some cases, it may be an explanation of how a case may be recommended to a central decision-making unit, or it may involve more localised decision-making based on additional material. The purpose of the interviews was to obtain information on the processes decision-makers use in banks, how loan applications are dealt with and the main reasons for acceptance and referral.

It is important to mention that, for each case, the managers' were unaware of the eventual outcome. This methodology formed the first part of the interview with the pre-seen case material. This was supplemented by the second part of the interview with a semi-structured questionnaire to reveal additional findings on issues on SMEs' finance from the bank managers' perspectives including start-ups and established customers.

The five SME cases which were developed for verbal protocol analysis by bank managers are summarised by feature in Table I. We discuss relevant demand side analysis for these categories of SMEs. It can be seen from Table I, that four of the five cases were concerned with manufacturing, all were relatively well-established and one in particular was concerned with the development of new products in order to enter global markets.

Table I: SME Cases Developed for Verbal Protocol Analysis

Case	Sector	Funding Required	Purpose	Size by Employees (FTEs)
One	Manufacturing	£1 million	NPD for growth in new markets	150
Two	Manufacturing	£50k	Purchase of new equipment	14
Three	Manufacturing	£100k	Re-structuring to achieve growth	15
Four	Manufacturing	£1 million	Growth by acquisition	81
Five	Retail craft and garden centre in rural environment	£450k	NPD and capital investment in new facilities	6

Findings

The development of the case material from the in-depth demand side analysis matched to some extent the categories of SMEs that theory and research evidence had suggested may face difficulties in accessing finance, although at the same time they presented sound business propositions. The discussion in this section focuses on informational analysis rather than reputational effects. To organise the discussion of the findings we focus on three categories of SMEs; manufacturing including new product development, location in a rural environment and younger SMEs and entrepreneurs.

1. Manufacturing SMEs

The demand side analysis found that the preponderance of manufacturing SMEs reporting problems accessing bank finance was quite remarkable. The 2006 ASBS survey had shown that manufacturing SMEs displayed a disproportionate importance, compared to other sectors in encountering problems in accessing bank finance. Manufacturing firms were found to exhibit twice the proportion of problems per bank application (30.3%) when compared to all other sectors (15.25). Table II illustrates the importance of manufacturing SMEs reporting problems in accessing bank finance. For example, manufacturing SMEs represent 19% of SMEs in the ASBS survey, yet they make up 46.2% of those reporting problems accessing bank finance, representing by far the largest category of SMEs by sector.

Table II SMEs Reporting Problems Accessing Bank Finance by Sector and Proportion in ASBS Survey

	Survey Sample		**ASBS 2006 Survey**	
	No.	**%**	**No.**	**%**
Primary	1	3	48	5
Manufacturing	18	46	187	19
Retail & Wholesale	7	18	288	28
Hotel & Catering	8	21	168	17
Professional Services	4	10	124	12
Education	1	3	5	0.5
Other sectors	0	0	194	19
Total	39	100.0	1014	100.0

The nature of problems reported by SMEs in general and manufacturing SMEs in particular were related to issues of the application process for debt finance at the banks. Tables III and IV illustrate that these problems focused on two aspects; the nature of the process of application itself and delays in obtaining decisions.

Table III: Issues Reported by SMEs Affecting Applications for Bank Finance

Issue reported	Proportion of SMEs reporting issue
Lack of sufficient security or issues in providing security	31%
Lack of trading record	30%
Lending process confusing or misleading	23%
Inadequate business plan	18%

Table III illustrates that a lack of trading record or insufficient security were reported as more important reasons for difficulties in obtaining debt finance than an inadequate business plan or poor financial projections. In addition to issues identified in Table III, several respondents complained that overdraft facilities, which they believed would be made available, were withheld or not offered. This was highly problematic for new businesses and buy-outs in sectors such as manufacturing, where stock purchase is essential and can lead to initial cash-flow difficulties in new businesses. It is worth noting that manufacturing businesses, in particular, encountered difficulties, in some instances reflecting problems in presenting complex technical development plans. Moreover, some manufacturing owner/managers voiced concerns about the lack of sectoral knowledge of bank lending officers. It was also noted that some more established businesses indicated that they had not been required to present a business plan. Several respondents complained that they *"…were never given an adequate or clear reason for being turned down."*

Delays in the decision making process were particularly problematic, as illustrated in Table IV. Over one half of all SMEs that were successful in their application had to wait over six months for a decision. This was a factor affecting the nature of relationships with manufacturing SMEs and, in some cases, these delays led to lost business opportunities, such as the failure to secure acquisitions. These owner/managers were at pains to stress how disappointed they were with the bank's approach. One respondent stated that *"banks keep putting up barriers and objections and you just have to keep battling away and stick with it, until they give in to you."* Another respondent stated that *"…we first made our application thinking that we would be able to secure the funds within a couple of months, but it dragged on for more than six months and it almost killed the deal."*

Table IV: Time Taken to Receive Bank Funding Decision

	Unsuccessful		**Successful**		**Total**	
	No.	**%**	**No.**	**%**	**No.**	**%**
Up to 1 month	3	23	5	28	8	26
2-3 months	2	15	3	17	5	16
4-5 months	0	0	5	28	5	16
6-11 months	2	15	4	22	6	19
12 months plus	6	46	1	6	7	23
Total	13	100	18	100	31	100

Note to table: 8 respondents were unable to provide an answer

From Table I, it can be seen that four of the five cases were concerned with manufacturing SMEs. We now report on the utlisation of verbal protocol analysis to discuss these four cases by bank officers. A summary of the issues and outcomes of these four cases is provided in Table V.

Table V: Summary of Issues Discussed by Bank Managers with Manufacturing Cases One to Four

	Financial modelling v credit scoring	Category Risk	Outcome
Case One	Financial modelling	High due to NPD and R&D required	Not supported/possible funding package
Case Two	Credit scored	Highly geared	Invoice discounting solution or package
Case Three	Financial modelling	Medium with restructuring	Likely to be rejected
Case Four	Financial modelling	Medium	Likely to be supported

Bank manager analysis of Case One

Case One was regarded as being in a competitive sector and was relatively highly geared. It was a difficult case for the bank managers to support having previous loss-making activities and limited levels of security. Bank managers also disliked the high reliance on one major customer for a high proportion of the company's existing turnover. However, they could see that logically there was a case for diversification. Whether this proposition could be supported would depend on whether it was an existing or new business customer. As a new business customer, without further equity it would be difficult to support and challenging. It would be approached with a good deal of caution and it was seen as relatively risky. If the company was an existing business customer, all the managers thought that the bank would seek to put together some sort of deal to help the company, even though it was recognised that this would be difficult. This was a difficult case for the banks to support as shown by Table V. All the banks stressed the importance of getting to know the managers/directors of the business and its products. The nature of relationship management with the bank would determine whether it could be taken forward.

Actual outcome

The actual outcome for this firm was that their application was turned down with the recommendation that they should approach equity investors instead. The main reasons for the refusal were: that the company was too highly geared, that they were too dependent on one customer and that they were in a high risk area, being a manufacturing business. The company eventually raised half the funding it was seeking (i.e. £500,000) from its existing shareholders which enabled the project to go ahead, but on a smaller scale.

Bank manager analysis of Case Two

Case Two involved a relatively modest amount with the smallest funding requirement and was expected to be relatively straightforward; however, a number of features were picked up by all the bank managers. One of these, and of an immediate area of concern for all the managers, was the high level of debt compared to turnover, with the company having £300,000 debt against a turnover of only £500,000. A further issue being that the company was trading with relatively small, individually priced items. In terms of process and protocols, although a small company, the bank managers indicated that they would still need to see the management and get to understand the nature of their business. It was considered that this would help to establish the nature of the £300,000 debt, which was one of the major concerns, particularly the extent to which this might be a bad debt. Some difficulties existed between the bank managers in how this case would be dealt with in terms of a solution, with some favouring an invoice discounting approach.

Actual outcome

The actual outcome for the SME involved was that the local branch of the bank that they normally used turned down the application. The bank had asked for a personal guarantee which the owner was unwilling to provide and the company eventually obtained £35k from equity investors, which allowed the project to go ahead on a smaller scale.

Bank manager analysis of Case Three

Case Three caused some difficulties for the bank managers as they saw it effectively as a downsizing within a competitive market and sector and regarded as being 'unconvinicing'. Although the case was categorised as a 're-start' in the information provided, managers interpreted this case as re-structuring to downsize the company. A difficulty for the bank managers was that two scenarios were involved in the case, one which was for the purchase of premises. If the purchase of premises was taken forward then one of the bankers commented that it would be necessary to bring in a more specialised retail team. Some of the bankers indicated a potential positive interpretation with an assumption that the company was progressive, innovative and seeking to focus on higher margin customers. All of them indicated that they would need to understand the management and the nature of the business, but indicated that if they could be satisfied about the more positive scenario, the proposal could be treated favourably. There were some differences of opinion expressed on whether the re-structuring could be a strength or a weakness. Some accepted that such a re-start or restructuring could be beneficial, especially in the sector which was seen as very competitive. There were comments by one banker that such re-structuring had been done with other companies in the sector to beneficial effect, particularly if it led to a concentration on higher quality, more profitable products. As a result, the bank managers were interested to obtain additional information on the competitive edge that the company could offer. However, one banker thought the re-structuring was a potential weakness as the view was that the company could have difficulty in adjusting to the market quickly. Thus for this case the bank managers had difficulty accepting the proposal to re-structure the company.

Actual outcome

The actual outcome for the company was that they were eventually successful in obtaining bank funding, although there was a delay caused by the protracted nature of negotiation between the company and the bank.

Bank manager analysis of Case Four
Case Four involved a specialised manufacturing concern seeking a new acquisition in order to obtain NPD and diversify. The company was relatively well-established, with a turnover of £4m, and it was a relatively attractive proposition to the bank managers. However, there was some concern expressed by the interviewed bank managers on the extent to which the company may be over dependent on certain large companies for a significant amount of its sales, who may subsequently switch to alternative suppliers. All the bank managers, however, were interested enough to judge that they would like to pursue an interest in the case. In taking this forward, given the nature of the business, the funding required and the stated purpose, all of them commented that a 'due diligence' process would be required with a business plan. They would need to satisfy that the debt would be serviceable. As in other cases, visiting the company's management and the premises would be essential. One banker considered that, dependent on the location, the case may be more appropriate for a more locally-based bank manager to take forward, the local manager would know the business, would have built up a relationship and would have taken it forward.

Actual outcome
The actual outcome involved the company applying to just the one bank which was the one it normally used. The presentation of the business plan, full financials with 3 year projections and due diligence reports on the intended acquisition went well and the company was given every indication by the local bank manager that they would be able to raise the finance. However, the application had to be referred to the bank's central committee who eventually decided to reject the application, just two days before the time period for the acquisition was up. A single reason was given for the application being turned down, this being that the company was too exposed, being dependent on just three main customers.

In summary, although in some of the SME cases funding was eventually achieved in all four cases, there were problems for manufacturing SME owners concerned with matching the information required by the bank, due diligence and the financial modelling process, timing and understanding of their businesses. However, the bank managers also indicated that they would spend time getting to understand the nature of the business and that for existing as opposed to new businesses a financial solution would attempt to be engineered. Combining the verbal protocol analysis with the survey findings, manufacturing SME owners are likely to be most affected by banks' protocol and informational requirements, particularly in situations involving new products, new technology and diversification.

2. SMEs in Rural Environments

Most of the SMEs that reported problems accessing bank finance were located in the urban areas of Scotland, which are located in the Central Belt. However, a significant minority of those reporting problems (10%) were located in rural areas, which cover large geographical and regional areas in the Highlands and Islands and in the South of Scotland. There is some evidence that some banks in rural areas may be used to dealing with applications from only certain sectors. For example, from the survey results, one tourist related business in Aberdeenshire complained that local banks only understood the oil industry and *"…it was only when we referred our loan application to the neighbouring region that the banks showed an interest in our proposal."* As discussed theoretically, bank managers in rural areas may also be unused to dealing with high growth SME proposals merely because they will be relatively unusual and they may lack experience to deal with them. Such proposals may be referred to central decision-making units located in the main cities of Glasgow and Edinburgh; however, this may divorce decision-making from local bank managers who will understand their local businesses and will have developed relationships. This scenario is close to that examined in more detail with the verbal protocol analysis interviews with bank managers with case five.

Bank manager analysis of Case Five

Case Five involved a company with a garden and a craft centre in a rural environment of Scotland seeking to diversify through investment in restaurant and additional facilities to increase capacity. Therefore, the case involved a small company in a rural location seeking a relatively large scale project. The location and the rural environment caused a number of concerns for the bank managers. Although several of the bankers were comfortable that garden centres could be profitable, citing known examples and, therefore, comfortable with the sector, the nature of the rural market 'was a problem'. Rural businesses have limited and dispersed local markets, unless there are any facilities that may attract seasonal tourist demand. There were concerns to understand the nature of the rural location. For example, one of the bankers was concerned to understand what rurality meant in the context of the company; that is, the extent to which the business enjoyed passing trade, or was it more isolated and difficult to get to. Seasonality was mentioned by some of the bankers, but this was less of a concern than what were perceived to be limited local markets and the possibility of relative 'isolation'. The nature of the location was also associated with issues with the need for additional marketing. Given the small size of the company with just six employees, questions were raised as to whether the company would possess sufficient marketing expertise to attract the additional trade which would achieve the required growth in the business. Therefore, a further concern was the relatively ambitious plans of the company compared to its current size, seeking a £450,000 credit facility with turnover of £120,000.

In terms of protocols and processes in taking the case forward, the bankers expressed a need to understand and clarify the rationale for the £450,000 funding requirement and also to understand the nature of the business, particularly addressing some of the 'rurality' and 'locational' concerns discussed above. There was some concern with understanding the nature of the business and management strategy, more in terms of what the company was trying to achieve in the nature of the business, with some discussion of whether they were focused on 'garden' or 'craft' products. One of the bankers expressed a need to meet and understand the key staff/directors. Given the nature of this case and the size of the facility, financial modelling would be required and one banker mentioned that additional sensitivity analysis would be required. One banker considered that a full business plan would be required. If taken forward, because of the nature of the proposition, the bankers discussed the need to get forward valuations of the proposed 'restaurant' facility. This would require separate quantity surveying costings and an independent valuation of the facility from their panel of approved valuers. All bankers stressed the need to satisfy serviceability requirements before taking security, but valuations would be required for security in this case. Given that the company was relatively recently established, it was considered that the Small Firms' Loan Guarantee Scheme might be applicable. One banker commented that they would need to clarify eligibility with the Department for Business, Enterprise and Regulatory Reform. One banker also commented that the relative complexity of the tax position for the directors meant that they would need to seek advice from a specialist tax accountant.

Actual outcome

The actual outcome for the company was that only after approaching four banks were they able to obtain sufficient funding to meet their borrowing requirement within the timescale. The lending bank was persuaded by the company's plans to lease out the restaurant to a restaurateur who was already a good customer of the bank. The bank required 130% of a guarantee which was secured against the company's property. However, this was only achieved after approaching several different banks and perhaps illustrates the need for SMEs with large scale projects for funding to approach several banks before they can be successful.

In summary, this case illustrated the importance of establishing a relationship with a local banker who would need to take it forward for approval by a central decision-making unit in an urban locality. SMEs in rural environments, therefore, are very dependent on the nature of the relationship with their local manager. The evidence from the survey is that the majority of SME owners are not prepared to shop around if their first approach to their local bank is not successful.

A general result for all SMEs surveyed was that only one third approached more than one bank, with two-thirds of respondents applying for bank finance only from their existing bank. It is perhaps surprising that so few firms 'shop around' when seeking bank finance, although given the evidence discussed later in this paper of the importance placed by lenders upon having a relationship with the finance seeker, this behaviour may be entirely rational. It is arguable that this is particularly problematical in Scotland given the limited competition and choice available to SMEs. For example, there was also a heavy dependence amongst the surveyed businesses on using the two main banks in Scotland. Table VI indicates that the Royal Bank of Scotland (RBS) and the Bank of Scotland (BoS) were by far the most frequently approached banks, representing more than three quarters (76 per cent) of the total applications for bank finance.

Table VI: Importance of Banks by Application

	1st Approached		All Approaches	
	No.	%	No.	%
Barclays	1	3	1	3
HSBC	1	3	2	5
Lloyds	2	5	2	5
Natwest	1	3	1	3
RBS	15	39	22	57
BoS	16	41	23	59
Clydesdale	2	5	5	13
Total	39	100.0	39	-

3. Younger SME and Owners

A third category examined is that of younger SMEs and owners. This draws together two categories of age of the firm as well as age of the entrepreneur. This was investigated through the interviews with bank managers via a discussion on general criteria. Additional interviews and consultation were undertaken with the Princes Scottish Youth Business Trust (PSYBT). The survey data, because it was derived from the ASBS survey was predominantly composed of well established SMEs with over 70% having trading records of five years or more, although SMEs trading for less than three years accounted for 29% of those reporting difficulties accessing bank finance. One young entrepreneur case study was developed from the demand side, but was not verified for the verbal protocol analysis by bankers, this case is referred to in more detail later in this section.

Demand side analysis of the SASBS 2006 focusing on issues for younger firms, trading less than four years, reveals some important differences to their older, more established, counterparts in the survey. Table VII, below, demonstrates that younger firms appear to be significantly disadvantaged with regard to accessing finance. Young firms exhibited a greater propensity to try to access finance and were twice as likely to try to access bank finance. However, young firms were also significantly more likely to encounter problems in accessing finance, notably with regard to accessing bank finance.

Table VII: SASBS 2006 Comparison between new and older firms' access to finance

During the previous year:	<4 years		4+ years		Total	
	No	Col %	No	Col %	No	Col %
Tried to access finance	35	39.4*	261	28.4	296	29.4
Problems accessing finance	15	16.9**	55	6.0	70	6.9
Bank finance sought	29	32.6*	161	17.5	190	18.9
Problems accessing bank finance	12	13.5**	23	2.5	35	3.5
Total	89	100	920	100	1009	100

Note: * significant at beyond .05 level
** significant at beyond .01 level
*** significant at beyond .001 level
5 cases answered 'don't know'

Further analysis reveals that young firms were twice as likely to require finance to buy premises (22.9%; n=35) and for staff development (5.7%), whilst their main reason for requiring finance was for working capital (34.3%). Young firms were also significantly (at beyond .05 level) more likely to seek mortgage finance than their older counterparts. Younger firms showed no propensity to seek grants, soft loans, or venture capital finance. Table VIII demonstrates that younger firms were twice as likely to experience problems in accessing finance and less likely to obtain either the full amount, or at least part of the funding that they required.

Table VIII: SASBS 2006 Problems accessing finance by trading age of firm

During the previous year:	<4 years		4+ years		Total	
	No	Col %	No	Col %	No	Col %
No funding received	6	17.1	28	10.7	34	11.5
Some funding received	5	14.3	13	5.0	18	6.1
Problems, but all funding received	4	11.4	14	5.4	18	6.1
Total problems	15	42.8	55	21.1	70	29.7
Total Seeking Finance	35	100	261	100	296	100

The main reasons for younger firms encountering problems in accessing finance related to lack of credit history (26.7%, n=15) insufficient security (13.3%) and poor business performance (13.3%). Evidence here is restricted by the widespread problem of poor feedback from lending institutions, with more than half of respondents (60%) in surveyed young firms indicating that little or no explanation was provided for full and partial refusals and delays in decision making.

Only a small proportion of surveyed firms in the Scottish Annual Small Business Survey (SASBS) 2006 had young owner-managers, under 30 years of age (42 cases, representing 4.2%; n=1001). However, evidence on younger SME owners is provided by one young entrepreneurs start-up case.

Young Entrepreneurs Start-up Case
The case concerned two recent graduates, each aged 23, who had the opportunity to buy an existing bar and restaurant business in Edinburgh. The young entrepreneurs sought a £100,000 bank loan to purchase the business. Several banks were approached but although they were initially encouraging, they all turned the application down. Whilst the business plan was accepted, the owners were seen as lacking previous management experience and lacked a business banking track record. They also did not have any collateral and were only able to put £10,000 into the business themselves. In the words of one of the founders "*the banks promised a lot but in the end delivered nothing*".

Turning to supply side analysis, this supported some of the difficulties faced by younger SMEs and owners. The importance of personal factors such as age, gender, and experience varied a little between the interviewed bank managers. There was some variability between bank managers on the importance of the age of the business owner. Some were concerned that, with older owners, there should be succession planning in place and one banker commented that, with younger owners, it is lack of experience that could be a factor. Another banker commented that 'age is not a barrier, but experience is'. Experience, generally is considered to be very important.

The PSYBT clients in Scotland are young entrepreneurs, less than 26 years of age, seeking to establish a new business. PSYBT support young entrepreneurs that qualify and satisfy their funding panel with a loan of up to £5,000 and a grant of £1,000. Successful clients are eligible for Development Loans of up to £10,000 and Accelerator Loans of up to £25,000 for business growth, if they have been in business for less than five years and are aged under 31. PSYBT considered that up to 15 per cent of their clients would seek commercial funding after the two year PSYBT support programme, but it was considered difficult for the client group to secure commercial funding due to the lack of personal credit history and a limited business trading period. It was considered that only about five per cent of clients of PSYBT succeed in getting any support from commercial banks at the start-up stage and that some of their clients go to three or four banks before being allowed to open a business account. Business Gateway and Highlands and Islands Enterprise are close enterprise partners and participate by referring 67.9 per cent of all new clients to PSYBT and by filtering out projects which are unsustainable (Scottish Enterprise, 2007).

In order to qualify for financial support a client of PSYBT has to be 'disadvantaged' and have used up any other source of finance that is available. PSYBT is seen as the 'lender of last resort'. In the case of young entrepreneurs, their age, lack of both experience and trading history can cause them problems with banks and other lenders. The evidence of market failure present in the PSYBT client group takes the form of a perceived problem of securing finance from external sources. Seventy per cent of respondents did not try to get funding from another source before approaching PSYBT, even though 61 per cent of them knew of other ways to secure finance. The reason given was a belief that they would be unlikely to obtain the necessary funds (Scottish Enterprise, 2007).

PSYBT makes 500 agreements a year, with typical lending on average £3,600 and, in their experience, 80 per cent of their clients repay on time. However, they did consider that a lack of financial record keeping is a problem, with only 25 per cent of clients having adequate financial records. Therefore, it is reasonable to assume that there would be problems with raising finance at the banks, once their clients are out of the Aftercare Scheme.

Overall, drawing on available evidence, it suggests that there is a funding gap for start-up and younger SMEs up to 3 years' trading and for younger SME owners below 30 years of age, despite the existence of special support schemes, funding and the PSYBT which provides specialised 'aftercare' advice service. As it is unlikely that younger SMEs and young entrepreneurs will be able to access equity sources much of this funding gap must be a debt gap. It arises because of a combination of factors compounded by not just youth, but limited security, lack of personal resources, limited trading records, credibility and alternative sources of finance. PSYBT estimated that there was a funding gap for their client base with relatively small amounts of funding, of perhaps less than £25k. In general a funding gap for smaller businesses was considered to exist for amounts less than £100k.

Conclusions and Implications

This paper has discussed demand and supply side research specifically conducted with SME owners and the main commercial banks in Scotland on SMEs access to debt finance. The paper has taken a thematic approach suggested by a theoretical framework which proposes that certain categories of SME owners will face the greatest difficulties in accessing bank finance, based on principles of asymmetrical information, trading records and the nature of relationship banking. These categories have been based on selected characteristics including sector (manufacturing), location (rural SMEs) and age of SMEs and the age of their owners (young entrepreneurs). This does not preclude that other categories suggested by the theoretical framework may also encounter debt finance gaps, such as women and black and ethnic minority entrepreneurs, but we suggest that these are more likely to be affected by reputational rather than informational processing effects.

The evidence from the demand side research gives some support to the argument that SME owners in manufacturing sectors face finance debt gaps. Of the 51 SMEs that were interviewed, the 39 that report problems accessing bank finance were disproportionately from the manufacturing sector. The survey evidence found that certain categories, which included manufacturing SMEs with projects related to NPD, were less likely to be successful. Delays to the application process was commonly cited as an issue from SMEs with two fifths of applicants for bank finance took more than six months to get a final decision. Delays were caused by referring applications to centralised teams and bureaucratic procedures, although over half of the businesses that reported difficulties in accessing bank finance were able in the end to undertake the whole project that they had required funding for. Overall, a third were unable to go ahead with the project because of a lack of funding. There was evidence that certain rural SMEs face difficulties accessing finance, such as where a rural SME had projects related to NPD and new markets, especially where this was combined with limited security.

The supply side interviews with bank managers revealed that banks have standard financial 'models' that are followed in terms of financial requirements, although there may be considerable discretion exercised by individual bank managers, dependent on seniority. However, the verbal protocol analysis revealed that there were circumstances in which sector and location of SMEs would affect their ability to raise bank finance. Although no sectors are excluded by the banks, SMEs in competitive sectors may find it difficult to raise finance, especially if they are operating in ways that do not fit the banks' own internal guides on benchmarking for the sector. A similar comment can be made on location. Rural locations can be difficult environments for SMEs, having limited local markets and limited networks and resources. Large areas of Scotland, the Highlands and Islands and the South of Scotland, qualify as rural under Scottish Government definitions[1]. SMEs in such localities seeking to grow and raise finance may find it difficult to raise bank finance, especially if reliant on local and regional markets.

Security was a secondary factor, but nonetheless important. Younger SMEs and owners with limited security will find it difficult to raise finance for propositions that contain higher risk or do not meet banks' financial modelling requirements. Changes to the Small Firms' Loan Guarantee Scheme following the Graham Review by the UK Government, has meant that the banks have in some cases reduced their use of the Scheme, moving from 'occasionally' making referrals under the Scheme to 'rarely'.

In addition, it is clear that bank managers would, as far as their discretion allowed, seek to support established businesses with which they have an existing personal relationship. The financial modelling process produces a result which indicates the category for the strength of the proposition in terms of risk/reward, but with latitude for bank managers to use discretion. However, given the segmentation applied by the banks, it will be easier for larger SMEs to obtain funding. Although how the SME market is segmented varies between the banks, micro and small firms are likely to have their propositions credit-scored (reducing the extent of bank manager discretion and flexibility). This is likely to make propositions from small firms that differed from bank 'norms', such as highly geared propositions with limited security, difficult to accept, especially if there are any issues with credit history and the trading track record.

A number of factors can affect the financial modelling process and hence the extent of latitude and discretion of managers. Entrepreneurs seeking to start new businesses will find it more difficult because of the lack of any trading history. In such circumstances previous experience, age and credit history of the entrepreneur will be important. These are likely to be credit-scored

[1] Although Scottish Government definitions of rural locations are different from standard ONS definitions based on size of settlements, these take account of the more dispersed patterns of settlement in rural areas of Scotland.

which may limit the flexibility that bank managers have, especially as such proposals are referred for final approval to a central credit department.

Combining these supply side factors with evidence from organisations such as PSYBT, provides some evidence that young entrepreneurs and owners of SMEs will face finance debt gaps which are only partially overcome through the additional financial and adviser support provided through schemes such as those operated by PYSBT and its counterparts such as, in Scotland, Business Gateway grant support for young start-up entrepreneurs up to 30 years.

In this paper we have sought to answer the following research questions:

RQ1: Whether reputational and informational effects can lead to market failure in the provision of debt finance.

RQ2: If market failure exists, what are the circumstances in which sound propositions are turned down?

RQ3: Whether such circumstances can be prevented.

We have focused on the evidence regarding the nature of banks' informational processing and its effect on categories of SMEs. We suggest that some categories of SME owners are affected through difficulties in their presentation of financial proposition to the banks and in the time taken to achieve decisions on their proposals. We recognise that these effects will be adverse for a relative minority of SMEs in general. Banks need to balance risk when faced with imperfect information and although banks have sophisticated financial modelling and market intelligence, there will be circumstances when good proposals are turned down. We contend that those circumstances are likely to be with manufacturing firms with NPD proposals and developments into new markets. Taking security can ameliorate some risk for the bank, but in some circumstances this is not available. New and younger SME owners, especially young entrepreneurs are most likely to be affected.

The third research question on whether the circumstances that can create market failure can be prevented is a more difficult question to answer. However, we do suggest that there are measures that can be taken by banks and policy makers that can reduce the existence of debt finance gaps which include the following:

- Banks could examine ways in which the decision-making process could be more timely. Although in most cases SME owners do receive decisions on proposals quickly. For relatively large investments, above credit proposals of £250k, delays can occur through the centralised nature of decision-making in a central credit decision-making unit. Although the role of the relationship banking manager should reduce the time taken by ensuring adequate information is provided, there were cases where delays seemed to be inordinately long.

- Banks could examine ways in which a pool of specialist managers in manufacturing and NPD could be developed. Although the role of the local bank manager is vital in terms of building the relationships with the SME, and found to be still strong and healthy, the development of a specialist pool of managers should be considered. Banks would benefit by having a support team for the local manager where asymmetric information problems are more acute.

- Policy-makers should consider additional training and focused support programmes with SME owners on the ways to approach banks, informational requirements and work closely with banks to provide additional advice and support to manufacturing SMEs.

- Relationship banking is crucial, banks with representatives of SME owners' organisations need to seek ways to develop these relationships. This may prove difficult with the increasing centralisation of banking services.

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