The Link between Competitiveness and SME Financing

Stijn Claessens, World Bank

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Purpose of presentation

- Show a measure of competition for banking systems for a large cross-section of countries
- Identify factors explaining differences
- Policy implications for competition policy
- Show data on degree of SME financing
- Analyze drivers of SME financing across countries
  - Factors driving SME financing in general
  - The effects of competition on SME access
- Policy implications for SME access

Motivation

- Competition is important in the financial sector
  - As in other sectors, competition affects efficiency, costs & incentives of financial institutions & markets to innovate
- Competition in finance, however, is complex, with tradeoffs
  - Structure matters, but in complex ways, e.g., effects of entry/exit rules, economies of scale/scope, networks, etc.
  - Too much competition can undermine stability, lead to crises
  - Access to credit depends on franchise value, but degree of competition can negatively and positively affect access
  - Financial services industries are continuously changing
    - Removal of barriers, globalization, increased role of non-banks, technological progress, increased networks
    - Affecting competitiveness and access

Competitiveness tests

- While complications recognized, studies on competition in finance still at early stage, particularly cross-country
  - New thinking on functional approach to financial services not incorporated as institutions are often studied
  - Lack of cross-country data, although improving recently
  - Many approaches do not take a formal approach to measuring degree of competition in markets
- Theory so far relies largely on general contestability
  - Baumol, Panzar and Willig, etc.: market structure not or not only important factor in determining competition
  - Applied in similar ways to financial services industries
- Only some specific analysis, e.g., credit cards markets

Competitiveness measure

H-Statistic (Pooled OLS)

1
0.9
0.8
0.7
0.6
0.5
0.4
0.3
0.2
0.1
0

Norway
United State
Spain
Ecuador
German
Pakistan
Denmark
Kenya
Australia
Dominican Republ
Austria
Italy
Paraguay
Croatia
India
Japan
Portugal
Belgium
Czech Republi
Latvia
Turkey
France
Panama
Switzerland
Philippine
Russian Federatio
United Kingdor
Ukraine
Canada
Nigeria
Indonesia
Lebanon
Venezuela
Netherland
Honduras
Malaysia
Argentina
Hong Kong, Chir
Chile
Colombia
Peru
Luxembour
Poland
South Afric
Hungary
Banglades
Costa Rica
Greece
Mexico
Brazil

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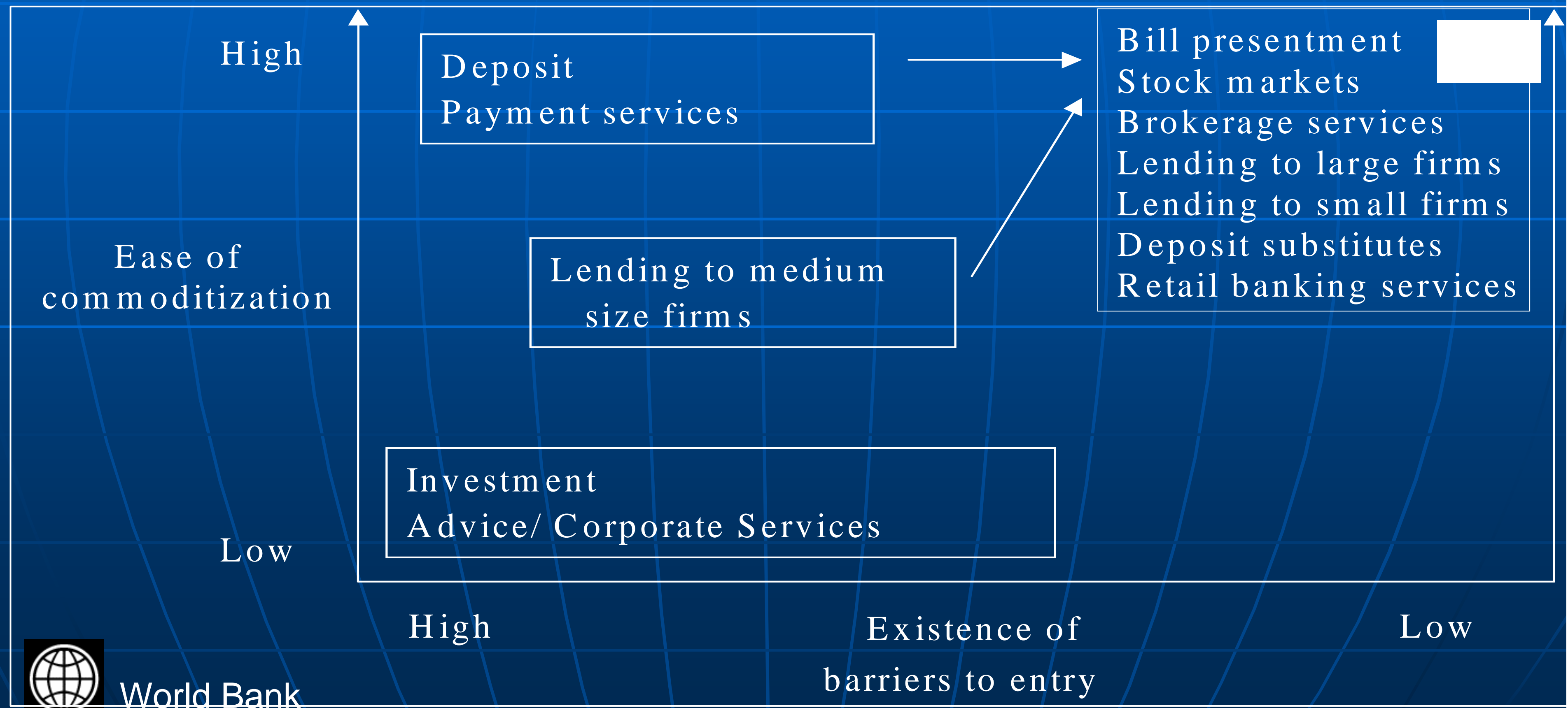
Determinants of competition

- Results suggest concentration and number of banks wrong measure for competition. Confirm IO that contestability rather than structure most important
- Concentrated banking system can be competitive
- Greater foreign bank presence, lack of activity restrictions → more competitive banking systems
  - Open to foreign entry & less restrictions important
- Some role of non-bank financial institutions in increasing competition policy
- However, large, unexplained variations. Country circumstances matter evidently a great deal

Competitive landscape is changing

- Many changes in production and distribution of financial services, altering financial services industrial structures
  - Deregulations, including removal of barriers between markets and products. Rapid technological progress



Implications for competition policy

- Theory and empirics: competition complicated. Importantly, need to consider financial services changes
- Traditionally: balance franchise value, important for prudential, special nature of banks, with competition
- More active competition policy possible and needed
  - Across institutions providing services & global: more competition
  - Finance and banks particularly less special → Reduction of safety net allows for more active competition policy
- Raising questions on competition paradigm
  - Do the newly emerging industrial structures require a different competition policy paradigm in the financial sector?
  - Can paradigm borrow from traditional IO or other (services)?
  - How to adapt to "special nature" of financial services industries?

New paradigm needed

- New competition policy to combine three approaches
  - <u>Institutional</u>: assure contestable markets by entry/exit of institutions, domestic and cross-border (all GATS modes)
  - <u>Functional</u>: assure contestable markets by leveling playing field across similar financial products (in all dimensions)
    - Requires competition policy to be more harmonized: Horizontal/vertical and service-specific & Globally, WTO, FTA
  - <u>Production</u>: assure efficiently provided, equally accessible, affordable network services (information, distribution, settlement, clearing, payment, etc.)
- Yet will remain difficult
  - Market and product definition; Barriers to entry may arise from sunk costs, economies of scale and scope, externalities
  - Network effects exist in supply, demand or distribution sides

Implications for competition policy

- Competition policy to resemble other network industries, e.g., TLC, so far only institutional & functional
  - Tools to adjust: less market structure, more conduct
  - More focus on access pricing and policies for market infrastructures (e.g., payments systems)
  - Overall information and technology competition policy
- Countries to give more weight to competition policy
  - Competition policy to be separate from supervision. Better enforcement by effective competition authority
  - Active role of government needed given externalities and coordination issues, e.g., payments system
- Countries commit to pro-competitive framework
  - When credibility at a premium, competition policy authorities weaker, political economy more adverse
  - International agreements (WTO, FTAs) can commit/enforce

SMEs: Sign, not Cause of a Successful Economy, but Need Finance

- While large SME sector characteristic of successful economies, SMEs do not "cause" growth, nor do SMEs alleviate poverty or decrease income inequality
- Rather overall business environment–ease of firm entry and exit, sound property rights, and proper contract enforcement–influences economic growth
- Finance, however, accelerates growth by removing constraints on small firms, more so than for large firms
- Finance allows firms to operate on a larger scale and encourages more efficient asset allocation. Financial and institutional development helps leveling the playing field

‘Access to finance’ recurrent problem for SMEs

- ‘Access to finance’ for SMEs recurrent problem
  - Anecdotal evidence, analyses and surveys
- Measuring access challenging though
  - Access for whom, for what?
    - What are SMEs, large firms? Trade, project finance, etc..
  - Which aspect of access?
    - Costs, quantity, quality, continuity, types of product, etc.
  - Access *vs.* usage
    - No demand, even with access
    - Growth opportunities: worse firms to complain most
- Need conceptual framework and measures
  - Econometric analyses or surveys

Measuring financing constraints (I)

- Investment – cash flow sensitivity
  - Empirical design based on:
    - Tobin's Q-model of investment
    - Euler equation for investment
  - Rigorous approaches, but with strong assumptions and much data needs (e.g., stock prices), not for SMEs

- Problems, especially developing countries
  - Classification (constrained or not) often arbitrarily
  - Data not detailed or reliable enough
  - SMEs dominate economic activity, with no/little data

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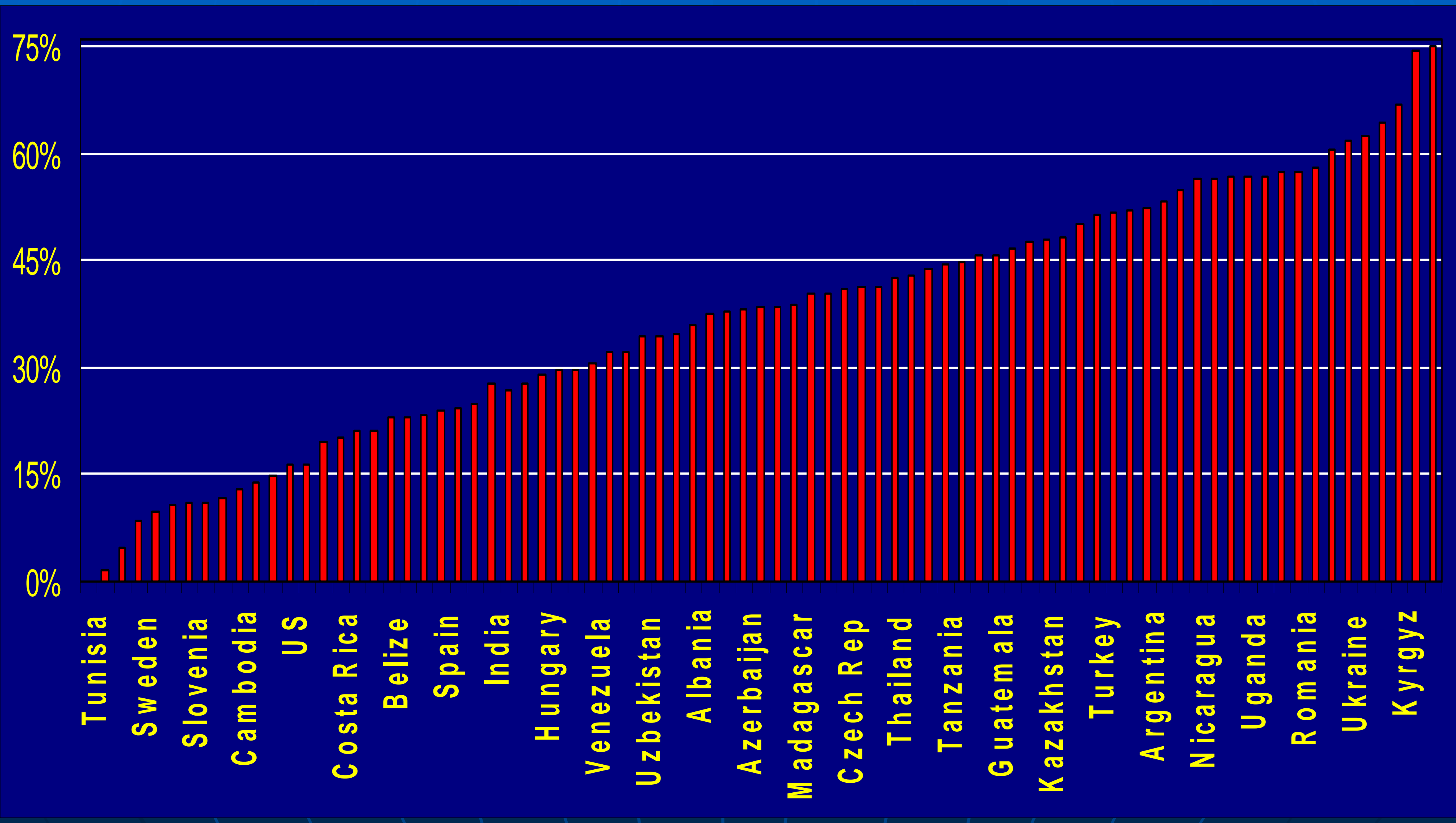
Measuring financing constraints (II)

- Surveys: ask if financially constrained
  - Especially for SMEs and developing countries surveys only way to get data and access measures
  - Results as expected: larger, older, more export-oriented etc. firms are less financially constrained
- Problems, especially for developing countries
  - Constrained in cost, quantity or quality?
  - Biases: bad firms more likely to report to be financially constrained, good less likely so. Can be "solved" by using control variables, but still limited

Results from surveys

WBES: Percentage of firms (non-state, non-foreign) that report financing as a major obstacle for their operation and growth



Who are banked and unbanked firms?

- To the extent known, profiles are as expected
  - Size is important. For large sample of countries, size strongest affects access to credit
    - Size more important compared to performance and other variables, suggesting quantitative limitations to credit access
    - Impact of size on credit is greater for longer terms loans
    - Public financial institutions more likely to lend to large firms
  - Size may reflect not only profitability, financial and legal collateral but also political collateral
  - Indeed, in developed countries size can be overcome
    - Traditionally banks lends to SMEs. Now also larger banks: Wells-Fargo in the US lends to many small, single proprietary firms. Other banks also active

What constrains SMEs' access?

- SME not served as it is a too high-risk, high-cost proposition for most banks
  - Underserved are new, not experienced in business
  - Even when business is viable, uncertain repayment capacity given volatile income and expenditure
  - High exposure to systemic risks (macro, other)
  - Absence of credit information, lack of collateral, difficulties in contract design and enforcement
  - High transactions costs for small volumes
  - Not conducive interest rates/credit subsidies policies
  - Government interference distorts risk-return signals

Constraints reflects mismatches of financial products

- Not the right type of financial services provided
  - Lack of products and services: e.g., small borrowers borrow frequently, repay in small installments
  - Small borrowers seek different products, e.g., small savings, lending and insurance (life, health, crop)
  - Transactions costs dealing with formal FIs high: e.g., procedures for opening an account/getting a loan are cumbersome and costly (with high rejection rates)
  - FIs demand collateral, which small borrowers lack
- Not clear what the market failure is, though
  - Why do FIs not offer these products if feasible?

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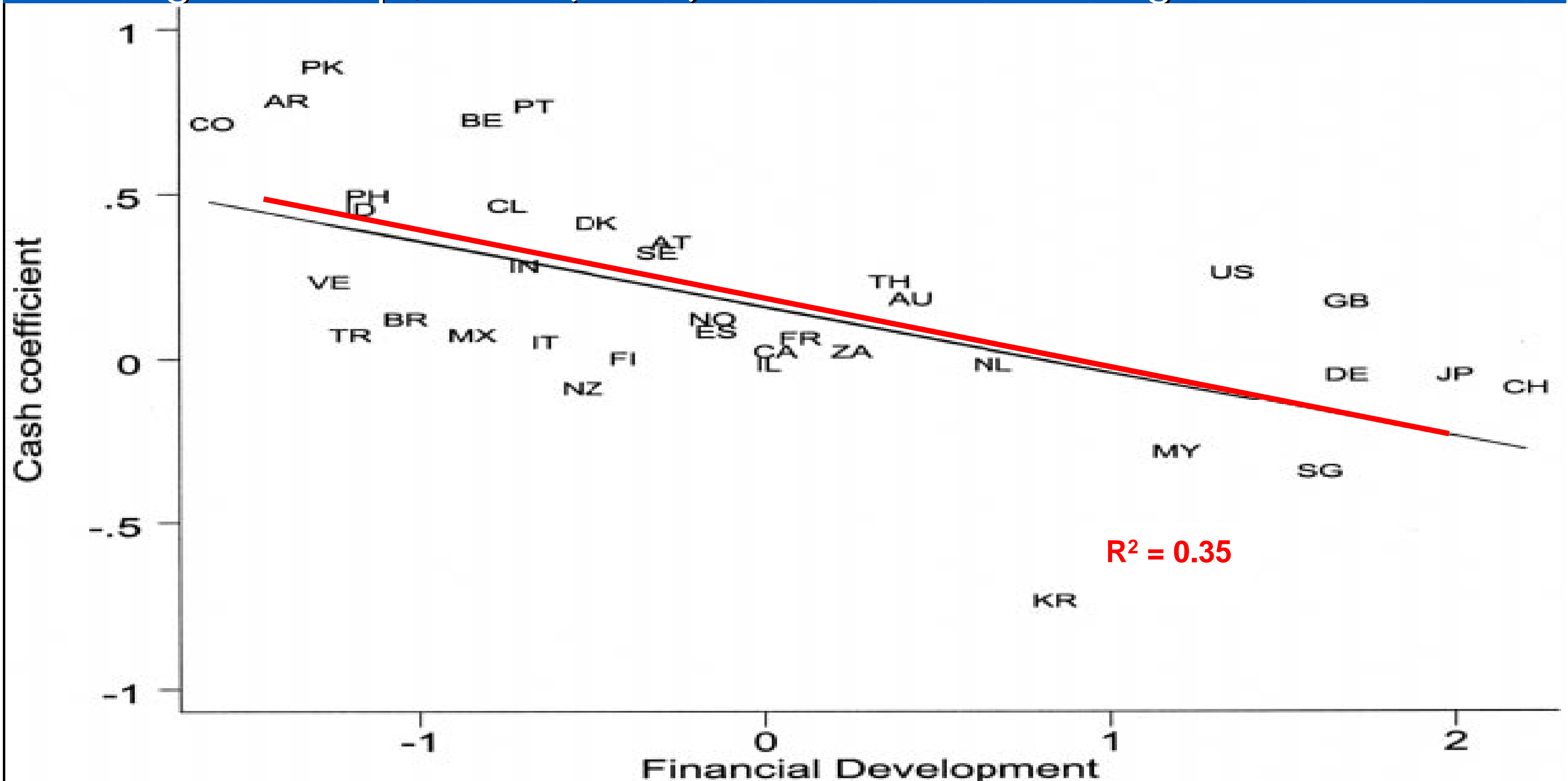
What is constraining SME access across countries?

- Analysis limited to date, but quality of legal, property rights, information, especially important for small firms
  - Small firms and in countries with poor institutions use less external finance, especially less bank finance
  - Protection of property rights increases external financing of small firms significantly more than of large firms, mainly due to more bank + equity finance
- Substitutes are imperfect, e.g., small firms do not use disproportionately more leasing or trade finance
- Financial sector development, correlated with these good policies, helps alleviate constraints

Results from investment – cash flow sensitivity regressions

Using Euler eqs, Love (2003) documents financing constraints



More developed, more liberalized → less constrained firms

Results from surveys

Greater financial development → fewer constrained firms

Informal finance for investment (%)

15
10
5
0

0 50 100

Private credit to GDP (%)

Sample: 44 developing and transition countries in 2004

Effects are most important beyond certain financial development, as firms then drastically decrease informal finance

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What other factors constrain SME access to financing?

- Regulations can hinder access
  - Interest rate ceilings, usury laws, restrictions on lending, priority lending
  - Rigidity in chartering, (high) minimum capital adequacy req., limited degrees in funding structures
  - Too heavy regulations and supervision, too strict accounting req., high compliance costs
  - Costumer identification ("Know Your Customer"), AML/CFT, other costly rules (e.g., see South Africa)
- But tradeoffs arise
  - Regulations serve other public policy purposes, e.g., stability, integrity, consumer protection

Better regulatory approaches can be relatively low cost

- Facilitate multiple forms of financial services provision, e.g., not just "banks" but finance, leasing, factoring
- Facilitate specific frameworks for activities of commercial banks on small scale, micro-finance institutions. Yet do not create new and distinct institutional forms unless:
  - Several mature and well-managed organizations are ready to transform into such financial intermediaries
  - Existing institutional forms— such as bank or finance company—are for all practical purposes unusable
- Consider savings separately from credit extension
- Develop anti-predatory lending, rather than usury laws
- Adopt "truth in lending" requirements to small scale
- Educate people/firms on risks of (new) financial services

Government interventions

- Facilitating credit by public interventions risky
  - Generally distortive, often do not reach intended, e.g.:
    - Subsidies for SME-lending captured by those with already access, middle class, well-connected
    - No additionality of general credit lines on growth
  - Institutional development undermined, banks do not develop credit skills, e.g., development banks' NPLs high
  - Setup subsidies can increase final costs as they lead to too small scale institutions that need to recover fixed costs
    - E.g., subsidies to setting up MFIs can lead to higher spreads
- Case for intervention in credit less clear than other
  - Need to keep the direct and indirect subsidies minimal
  - Costs and risks co-sharing with private sector key

How to further enhance access?

- Institutional infrastructure improvements, but take time
  - Better legal, information, payments systems, distribution, other
- Public interventions facilitating mainstreaming, scaling up of new initiatives possibly useful, but be careful
  - Can sometimes be done by specific interventions
  - Use existing networks, e.g., postal system to deliver new services by many, private providers (India). Sell postal to private banks (Brazil), better services but risks local monopoly
- New technology and other initiatives can help
  - Mobile banking / broadening range of delivery points
  - Scoring models for SME-lending
  - Pre-paid cards for small transactions
  - Reverse factoring by NAFIN in Mexico using internet platform
- New technology though often needs regulatory changes

Competition and SME financing

- Improving competition in banking systems
  - Can be done easier, in all segments. Also can provide more (foreign) technology and know how
  - Allow non-bank financial institutions access to existing networks (payments system), especially access to positive and negative credit information (credit bureaus)
- But remains complex, especially in emerging markets
  - How to establish a credible competition agency? Inside or outside supervisory agency. Institutional requirements high
  - Limited data to measure effective competition
  - How to deal with the many network properties in finance?

Foreign banks enhance access

- Borrower's perceptions across 36 countries
  - Financing obstacles lower in countries with more foreign banks
  - Strong evidence that even small enterprises benefit and no evidence they are harmed by foreign banks
  - Channel is both competition and direct provision of finance
- Latin America study
  - Foreign banks with small local presence not lend much to SMEs
  - But large foreign banks in many cases surpass domestic banks
- Transition economies, with large foreign bank entry
  - Foreign banks lend less to state-owned enterprises. Little evidence that entry leads to cream-skimming, undermining local banks' ability for soft information/relationships lending
  - Evidence that private credit is higher in countries with more foreign presence/entry (yet causality unclear)

Competition and access

- SME depends on relationships. Competition can:
  - Lower profit: lower access for information-intensive firms
    - Evidence for US/elsewhere: less access with more competition
    - Dynamic effects: bank invest less in information acquisition
  - Lower hold-up problems: lower costs, de- or increase access
    - Evidence: multiple bank relationships lower access
- Technology further complicates, with hard-information ↑
  - Effects of technological innovations, access to information, pattern of entry/exit often ambiguous on competition/access
- Tradeoffs unclear
  - With more competition → more access generally
  - But access to information-intensive firms may suffer

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Competition and SME financing

- Lending towards hard information everywhere
  - While trends appear clear, do not know good or bad, how depends on country circumstances, etc
  - But there may not be an alternative whatsoever
- At the same time banks' comparative advantage is relationships (and risk management)
  - Banks make investments in technology & relationships, based on returns, in turn affecting competition & access
- Banks may well end up doing more relationship-based services (and more risk management)
  - Relationships already cover wide spectrum of services
  - Entry of small banks (in US) specializing in small firms
  - Other forms of financial services for SMEs

Policy Conclusions

- Competitiveness in financial services
  - Is not about market structure, but ensuring contestability
- Competition policy is lagging in finance
  - More emphasis and new paradigm is needed
- Competitive system is key for SME financing
  - Require basic institutional environment
  - Some specific interventions can help, especially access to information and networks
- Banks will remain major source of SME financing
- Competition has positive and negative effects
  - May lower traditional access forms, yet reduce costs
  - But strengthens returns to banks from relationships across wider spectrum of services
  - Overall effects perhaps unclear, SMEs no choice but adapt

End of presentation

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