evidence
BRIEFING

E·S·R·C ECONOMIC & SOCIAL RESEARCH COUNCIL

RESEARCH AND RELEVANCE TO KEY POLICY AREAS

Providing funding for innovative SMEs

The House of Commons Inquiry on 'Bridging the Valley of Death: Improving the Commercialisation of Research' is exploring the difficulty of translating research into commercial application. Dr Paul Nightingale, who has given evidence to the inquiry, provided research on how banks could be encouraged to lend to innovative SMEs.

Commercialising research, encouraging innovative companies and supporting start-ups of small and medium-sized businesses (SMEs) are vital in generating new jobs and driving innovation.

However, SMEs are also the most likely to face financial restraints on their growth. Recent banking reforms such as the requirement for banks to hold more capital could make lending to innovative SMEs more difficult, but lending could be encouraged through targeted policies.

A knowledge-based economy, based on intangible assets that cannot be used as collateral for loans, presents financial challenges which are often different to the conventional lending activities undertaken by UK banks. Bank assets in the financial services sector have grown to more than four times British GDP but lending to UK corporates constitutes only five per cent of lending.

The costs of making loans to small firms and medium sized firms are similar, but the profits from providing services to smaller firms are less, making them relatively less attractive investments. The debt instruments used by banks do not provide extra benefit to the banks if the firm does well, while the use of equity instruments that do provide upside benefits are under-developed in the UK. Moreover they are extremely difficult to operate profitably with SMEs.

A Work Foundation report, The Discouraged Economy, supported by NESTA and building on ESRC-funded research, shows that while most firms with collateral eventually receive the funding they seek, banks are not lending to two groups of firms:

- higher risk firms who are refused credit, rather than being offered higher interest rates that reflect their higher risks.
- firms with growth ambitions and potential who do not have collateral.

This is partly an outcome of the shift in banking towards using credit-scoring methods to assess loans, rather than relying on traditional relationship-banking where bank managers have a deep understanding of their customers and more discretion when making loans. The current scale of banking creates strong incentives for conformity to this business model, and substantial barriers for new banks that might offer better services.

Current practice results in a group of discouraged borrowers - firms that have legitimate investment opportunities and would be funded if they asked banks for a loan, but believe that they would be refused and therefore do not ask. The lack of investment leads to a self-reinforcing cycle of less innovation, less investment and less dynamism.

Evaluations of a number of UK government schemes to support lending to these firms using relationship-banking methods show that even 'emergency scheme' policies, introduced in a recession, perform relatively well. This suggests that new policies may be needed to address the various failures in the market for lending to innovative SMEs.

Key findings

- Most firms with collateral eventually receive the funding they seek. However, for a significant number of firms loans are not forthcoming.
- Banks avoid lending to two groups of firms:
  - higher-risk firms who are being refused debt rather than being offered higher interest rates that reflect their higher risks
  - firms with growth ambitions and potential who do not have collateral

  This reduces investment and produces a sub-population of discouraged borrowers.
- Public policies to support lending to SMEs have been effective, suggesting there is demand for additional lending services, but it is unclear if these can be offered on a commercial basis.

Policy relevance and implications

The problems that SMEs face in accessing finance are more complex than media portrayals of banks simply not lending. There are problems with both the supply and demand for investment. Targeted policy measures could make lending to SMEs less risky and more financially attractive.

- Allowing banks to take SME debt off their balance sheets may help stimulate lending to high-growth innovative SMEs, by creating an environment where SME lending does not consume as much scarce, expensive risk capital.
- The entry into the UK market of new financial institutions with new business models may be needed to improve lending to innovative SMEs – such as European banks relying on traditional relationship-banking, and new online institutions for trading SME equity and linking investors with firms seeking investment.

BRIEF DESCRIPTION OF THE RESEARCH

A Work Foundation report, The Discouraged Economy, supported by NESTA and building on ESRC-funded research, has identified two categories of SMEs without access to funding from banks – higher-risk firms and firms without collateral. This leads to a group of 'discouraged borrowers' who do not apply for loans even when they are eligible, resulting in less investment and less innovation. The report was submitted as evidence to the Independent Commission on Banking July 2011.

Will Hutton and Paul Nightingale: *The Discouraged Economy* (The Work Foundation)

Web: www.theworkfoundation.com/Reports/302/The-Discouraged-Economy

FURTHER INFORMATION

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