



A more complete conceptual framework for SME finance [☆]

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Abstract

We propose a more complete conceptual framework for analysis of SME credit availability issues. In this framework, lending technologies are the key conduit through which government policies and national financial structures affect credit availability. We emphasize a causal chain from policy to financial structures, which affect the feasibility and profitability of different lending technologies. These technologies, in turn, have important effects on SME credit availability. Financial structures include the presence of different financial institution types and the conditions under which they operate. Lending technologies include several transactions technologies plus relationship lending. We argue that the framework implicit in most of the literature is oversimplified, neglects key elements of the chain, and often yields misleading conclusions. A common oversimplification is the treatment of transactions technologies as a homogeneous group, unsuitable for serving informationally opaque SMEs, and a frequent misleading conclusion is that large institutions are disadvantaged in lending to opaque SMEs.

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1. Introduction

The availability of external finance for small and medium enterprises (SMEs) is a topic of significant research interest to academics and an important issue to policy makers around the globe. The conceptual framework to which most of the current research literature adheres has been quite helpful in understanding the institutions and markets that provide funds to SMEs in developed and developing nations. This framework has also provided insights into the effects of policies that affect access to funding by creditworthy SMEs in these nations. However, we argue that the current framework is oversimplified, and neglects key elements of the financial system that affect SME credit availability.

We propose a more complete framework in which lending technologies play a key role as the conduit through which government policies and national financial structures affect SME credit availability. We define a lending technology as a unique combination of primary information source, screening and underwriting policies/procedures, loan contract structure, and monitoring strategies/mechanisms.

An important oversimplification in the current framework is the way that lending technologies are often categorized into two types: transactions lending that is based primarily on “hard” quantitative data and relationship lending, which is based significantly on “soft” qualitative information. Under this categorization, transactions lending is generally viewed as being focused on informationally transparent borrowers, while relationship lending is seen as used for opaque borrowers.

In our view, this characterization is fundamentally flawed. Transactions lending is not a single homogeneous lending technology. There are a number of distinct transactions technologies used by financial institutions, including financial statement lending, small business credit scoring, asset-based lending, factoring, fixed-asset lending, and leasing. While financial statement lending is focused on transparent borrowers, these other transactions technologies are all targeted to opaque borrowers. Recognition of this heterogeneity among transactions technologies and its impact on credit availability to opaque borrowers is often missing from the academic literature.

Our framework specifies a causal chain from government policies to a nation’s financial institution structure and lending infrastructure. These financial structures, in turn, significantly affect the availability of funds to SMEs by determining the feasibility and profitability with which different lending technologies may be deployed. Financial institution structure refers to the market presence of and competition among different types of financial institutions and lending infrastructure refers to the rules and conditions that affect the ability of these institutions to lend. The extant research literature often neglects key elements of this causal chain, which may yield misleading research and policy conclusions.

To illustrate, consider the recent research on financial institution size, one dimension of financial institution structure. A common finding is that large institutions have a comparative advantage in transactions lending to SMEs based on hard information, while small institutions have a comparative advantage in relationship lending based on soft information. A policy implication that might at first blush seem reasonable is that the financial

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