

The effect of the credit crisis on UK SME finance

This evidence briefing is aimed at policymakers concerned with stimulating growth of SMEs. It summarises the findings of the UK Survey of SME Finances, conceived and developed by the Centre for Small and Medium-Sized Enterprises (CSME), Warwick Business School.

Key findings

The survey was carried out against the backdrop of the worst global financial crisis in 80 years. The objectives were to:

- Measure the impact of the credit crisis on the cost and availability of credit to SMEs.
- Develop and estimate a model of small business default risk under uncertainty (the default risk distribution) and examine the relationship between the default risk distribution and the availability of finance.
- Test relationships between finance gaps and firm performance to gain insights into the presence of financial constraints, and the nature of informational asymmetries – where entrepreneurs know more about the prospects of their businesses than the banks they apply to for loans – in the UK market for small firms' credit.

In terms of the first objective, the researchers produced a report on changes in the availability and cost of finance for small firms. The key findings were that in 2008 (compared to 2004):

- Overdraft rejections increased 3½ times (4.2% to 15.3%)
- Term loan rejections increased 2½ times (6.1% to 16.3%)
- Average size of overdraft facilities loans increased by 30% (£36,500 to £47,500)
 - but decreased by 75% among high risk firms (£58,000 to £14,500)



- Overdraft margins increased by 83% (2.4% points to 4.4% points over base)
- Overdraft arrangement fees increased by 86% (£237 to £442)
- Term loan margins increased by 68% (2.2% points to 3.7% points over base)
- Term loan arrangement fees increased by 37% (£1,074 to £1,468)
- There was no change in average incidences of collateral
 - but there was a 78% increase (33.3% to 59.4%) in collateral posted on loans by low risk firms

These results show that while loan rejection rates increased significantly in 2008, at the same time average loan amounts increased. However lower risk firms, in particular those with collateral, were the main beneficiaries of these increases; higher risk businesses, which would have found it relatively easy to access loans during the credit boom, found their supply of credit substantially reduced.

It would therefore seem that banks, to meet lending targets set by the Government, lent larger secured loans to low risk borrowers whilst reducing credit availability to higher risk borrowers and those without collateral.

In terms of the second objective, the research led to the development of a model of the small business default risk distribution implied by the likelihood of loan rejection. The model was used to test two hypotheses about the impact of the credit crisis on the availability of loans to small firms.

These hypotheses seek to identify the direct (financial) and indirect (real economic) effects of the crisis on the availability of loans. The first hypothesis (H1) states that loan rejection rates increased in 2008 due to a tightening of loan approval thresholds as capital became less available and more expensive to banks.

However the restriction of credit to consumers and businesses lead to reduced aggregate demand which increased the likelihood of business failure.

Accordingly, it is argued in the second hypothesis (H2) that the likelihood of loan rejection was further increased due to an upward shift in the default risk distribution. The empirical analysis indicates that in total loan rejection rates increased by about 13% points in 2008: about 6% points of this increase was due to a tightening of loan approval thresholds (H1); and the remaining 7% point increase was due to an increase in default risk (H2).

In terms of the third objective, the research has led to the development of a regression based test of financial constraints based on a model of the relationship between firm level finance gaps (the difference between the demand and supply of finance) and firm performance.

Under financial constraints the model predicts a negative relationship between finance gaps and firm performance. Alternatively, if finance gaps are due to factors other than financial constraints (such as entrepreneurial over-optimism leading to excess capital demands) the model predicts there is no relationship between finance gaps and performance. The test was applied to sales growth in 2003-4 and 2007-8 respectively. The key finding is that finance gaps were significantly negatively related to sales

growth in 2007-8 but not 2003-4. This confirms that business growth was constrained by a lack of finance during the credit crisis (but not in the credit boom).

In conclusion

The research confirms that the credit crisis and ensuing recession have led to both a tightening of loan approval thresholds (due to the crisis in financial markets) and an increase in default risk (due to the ensuing recession), contributing to the poorer availability of credit in 2008.

Brief description of the project

Published in 2010, the UK Survey of SME Finances (UKSMEF) 2008 is the latest in a series of surveys which examines large, representative samples of UK businesses with less than 250 employees. UKSMEF was conceived and developed by the Centre for Small and Medium-Sized Enterprises (CSME), Warwick Business School.

Further information

This briefing is a summary of the full report by Dr Stuart Fraser, the Centre for Small and Medium-Sized Enterprises, Warwick Business School, University of Warwick

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The full report is available at:

www2.warwick.ac.uk/fac/soc/wbs/research/csme/research/latest/small_firms_in_the_credit_crisis_v3-oct09.pdf

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