

**IS THERE A FINANCE GAP FOR SMEs?  
SOME EVIDENCE FROM RECENT STUDIES IN SCOTLAND AND LONDON**

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**ABSTRACT**

*The aim of this paper is to investigate whether or not there is still a finance gap for SMEs. The paper draws on evidence from two recent studies relating to accessing external finance by Scottish and London SMEs in order to assess the extent and nature of gaps in the market for SME finance. Both studies were concerned with obtaining demand and supply side perspectives using both primary and secondary data sources. The findings from both studies suggest that there continues to be specific gaps in the SME finance market and that these are most apparent for manufacturing SMEs, start-up and young firms, and businesses led by women and ethnic minority entrepreneurs. Given the present economic downturn, it seems that the impact of the credit crunch in the UK will exacerbate the funding gaps experienced by those types of SME that were already facing the greatest difficulties in raising external finance.*

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**1. INTRODUCTION AND THEORETICAL CONTEXT**

This paper contributes to the continuing debate about whether or not there is still a finance gap for SMEs, drawing upon two recent studies on SME access to finance within the United Kingdom. The first study was undertaken for the Scottish Government and focuses specifically on access to debt finance from banks (Scottish Government, 2008), whilst the second study was undertaken in 2008 for the London Development Agency and relates more generally to the extent to which London SMEs are experiencing problems in accessing finance from external sources. These studies have therefore been conducted in a Western European economy which is generally recognised as having a well developed financial infrastructure and venture capital/equity market compared to many transition and emerging economies.

Whether or not there is market failure relating to SMEs access to finance in the UK has been a much debated issue and the subject of several government investigations (notably the Macmillan Report of 1931 and the Wilson Committee in 1979) as well as a number of major research studies (e.g. Bank of England, 2004). As a result, various supply-side improvements have been made, for example, in the provision of advice and assistance to entrepreneurs and SME owner-managers including improved awareness of bankers' requirements, help with making propositions more fundable, initiatives by regional economic

development agencies on venture capital and loan finance and micro-credit schemes, and a greater emphasis by the commercial banks themselves on relationship banking. Moreover, the existence of the UK Government's Loan Guarantee Scheme since 1981 has been designed to address the problem that some firms with commercially viable business propositions are unable to provide the levels of security and collateral required by the banks. The announcement by the Bank of England that it was no longer going to produce an annual report on the finance of small firms after 2004 would suggest that the official view is that there is no market failure in the provision of bank (debt) finance to SMEs. Since then, little attention has been given to SMEs' access to debt finance. Instead, the focus of attention has tended to shift towards the existence of an equity gap rather than a debt gap; for example, the UK Government's former Small Business Service review of evidence on access to finance suggested that "small businesses find it difficult to obtain modest amounts of private equity finance" (SBS, 2005).

Financial market failure has been defined as "the failure of the financial markets to provide finance to apparently viable firms" (National Economic Research Associates, 1990). The emphasis here needs to be placed on **viable** firms, since it is a common finding of small business surveys that owner-managers who have been unsuccessful in obtaining finance will say that finance is a barrier to their growth, yet their failure to obtain finance may be because of weaknesses in the business case they are putting forward. Thus even when the market is working well, there are likely to be businesses with an unsatisfied demand for finance. For this reason, the notion of there being 'finance gaps' is arguably more helpful than that of 'market failure'. Moreover, as Storey (1994) observes, gaps can exist for understandable market reasons (such as the reluctance of small business owners to share ownership with finance providers or their unwillingness to pay high bank charges and/or interest rates). Market failure is also a difficult issue to prove conclusively, since judgements are required about the future viability of propositions and in the case of investment finance, trade offs made between the degree of risk that funding organisations are prepared to take and the size of potential rewards. The notion of 'market failure' also implies that this is an abnormal and temporary state of affairs, yet the contrary view is that markets are behaving imperfectly all the time, leading some commentators to suggest 'the failure of market failure' as a useful diagnostic tool for deciding on the need for policy intervention (Zerbe and McCurdy, 2005).

Much of the discussion relating to market failure has concentrated on two key aspects of the relationship between entrepreneurs and SME owner-managers on the one hand and finance providers on the other. In relation to bank lending, the focus has been on two aspects in particular namely, asymmetric information and reputational effects. Asymmetric information means that there will be some proposals on which bank officers will not have 'perfect' information. Stiglitz and Weiss (1981) classically argue that 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, suggesting the existence of credit gaps. Instances of market failure resulting from asymmetric information are thought to occur in relation to new and technology-based propositions for which market intelligence will be limited. 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). In addition, there may be asymmetries arising from location as well as sector. For example, SME owners and entrepreneurs in rural environments may face difficulties with access to bank finance (OECD, 2008). This is supported by a study conducted by Felsenstein and Fleischer (2002) in which public assistance for small scale entrepreneurship in peripheral areas was analysed

and found that information asymmetries make peripheral firms unattractive to lenders. Although a consensus has emerged that asymmetries produce credit funding gaps, de Meza (2002) contends that over lending results from asymmetric information because entrepreneurs are over optimistic about their returns and consequently inflate their requirements in applications for funding to the banks.

Reputational effects apply, theoretically, where entrepreneurs are prevented by their own or others experiences from applying for debt finance. This provides a 'discouraged borrower effect' i.e. some entrepreneurs may not access finance because at some stage they are discouraged from applying (Kon and Storey, 2003; Fraser, 2005). 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 business owners 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 reputational effects (Watanabe, 2005). The perception of a finance gap may reduce the willingness of entrepreneurs to approach the banking network to secure appropriate financing, resulting in some potentially viable business propositions not going ahead. A report for the former UK Government's 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."

Overall, the relevant literature provides some consistent evidence to suggest that there are a number of categories of SMEs that could be affected by informational issues or reputational effects. Therefore, there may be finance gaps affecting certain categories of SME. This paper focuses on the extent to which four different types of SME faced problems:

- a) Young firms
- b) Manufacturing SMEs.
- c) Women-owned SMEs.
- d) Black and Minority Ethnic Businesses (BMEBs)

It will therefore consider the extent to which the evidence from the studies carried out in Scotland and London shows that these categories of SME have disproportionately faced problems in accessing external finance and whether this can be attributed to informational or reputation effects. Before focusing on the empirical findings, the next section of the paper summarises the research methodology employed in each of the studies.

## **2. RESEARCH METHODOLOGY**

### **a) Scotland Study**

A distinctive aspect of this study was that it adopted both a demand-side and supply-side perspective to the question of whether or not Scottish SMEs were experiencing difficulties in accessing external finance and bank finance in particular. The key question at the heart of the research was whether firms were experiencing difficulties because of the unsuitability of the business case they were putting to finance providers (i.e. demand side

issues), or whether the difficulties resulted from sub-optimal lending practices, resulting in some potentially viable proposals being rejected (i.e. supply side issues). The research consisted of a number of linked stages:

The first stage was to undertake analysis of the questions on access to finance in the 2006 Annual Small Business Survey (ASBS) (Scotland). This was based on a sample of 1014 surveyed SMEs, 29.2 per cent of whom had attempted to access external finance in the 12 months leading up to the survey, and 6.3 per cent (i.e. 64 SMEs) indicating problems in accessing finance. As well as information on various characteristics (e.g. age, sector, growth orientation) of the businesses, the ASBS survey provides data on the nature of the difficulties the businesses experienced, the type and amount of finance sought, and reasons for the difficulties.

The second stage consisted of a follow-up in-depth telephone interview survey of SME owner-managers that had indicated they had experienced problems in raising external finance as part of the ASBS (Scotland). These comprised businesses that: (i) obtained no finance; (ii) obtained less finance than they required; or (iii) obtained what they required but with some difficulty. This led to 51 completed interviews being undertaken in July-August 2007 of which 39 related to applications for bank finance. The telephone interview survey also acted as the basis for selecting a small number of test cases of firms that, prima facie, appeared to have put forward a strong business case for bank finance. Seven cases were developed that met the prima facie case. These cases provide instances of where a seemingly good business proposition had been rejected for debt finance or where the failure to obtain external finance had seriously curtailed the growth of the business.

The third stage focused on verification of the chosen seven case scenarios through the analysis of an independent banking expert. As a result of this verification stage, five cases providing a range of scenarios, size of business, turnover and credit requirements were eventually taken forward to the fourth stage which involved putting the cases before bank managers in order to investigate their procedures and criteria for evaluating business cases, using verbal protocol analysis. Interviews were held with eight bank lending officers. 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.

#### b) London Study

The London study was concerned with establishing the type, size and scope of funding needed by London's SMEs and to determine the nature and extent of market failure issues including identifying any finance gaps. As with the Scotland study, it involved a number of stages including a series of demand-side and supply-side interviews.

The first stage was to undertake an analysis of the questions in the 2007 London Annual Business Survey (LABS) (undertaken by the London Development Agency) relating to accessing finance. This was a survey of 4527 businesses, 20 per cent of whom had approached external sources for finance in the 12 months prior to the survey, with 12 per cent reporting difficulties in accessing finance.

The second stage consisted of a number of demand-side interviews in order to obtain further insights into the nature and extent of the difficulties London SMEs are facing. These included interviews with 35 SME owner-managers that as part of LABS 2007 had identified problems in accessing finance. The interviews were able to go much further than the LABS survey in asking owner-managers about the nature of the finance sought, their experience of different sources, the reasons for the problems experienced, their views about alternative

external sources, and also their assessment of their future financial needs. In addition, a number of interviews were conducted with accountants and business advisors who dealt directly with SMEs about the financial needs and experiences of their clients.

The third stage comprised a series of face-to-face interviews with finance providers including bank managers, private venture capital organisations, representatives of business angel networks, and finance advisors. These interviews asked about the decision-making processes and protocols used in making loan and investment decisions to SMEs, the main reasons for acceptance and referral, and their views on whether gaps existed for certain types of finance and if so, the principal causes for them.

For both the Scotland and London studies, a strong research team was recruited with previous experience of researching SME finance and interviewing specialist funders and bankers. All the authors were directly involved in the interviews for both studies. Consistency was applied with flexibility to minimise bias whilst retaining the scope for respondents to have full freedom to provide extensive views and interview data.

### **3. FINDINGS AND DISCUSSION**

We now examine the evidence from the Scotland and London studies relating to the four categories of SME identified above to see to what extent they have been experiencing a higher incidence of difficulties in accessing finance than SMEs in general and if so, whether this can be explained at least in part by information asymmetry and reputational effects. The findings will be discussed in the context of the literature and other research relating to access to finance for each type of SME.

#### **3.1 Younger SMEs and Entrepreneurs**

There is clear evidence from the study of Scottish SMEs that a disproportionate number of younger SMEs were facing difficulties in accessing external finance. As Table 1 shows, there were important differences between firms trading for less than four years and their older, more established counterparts. Whilst younger firms exhibited a greater propensity to try to access finance, they were also more likely to encounter problems in accessing it, with 17.1 per cent of them not receiving any finance (Table 2). The age of the business proved particularly significant when applying for bank finance, since 13.5 per cent of early stage businesses experienced problems compared with just 2.5 per cent of more established SMEs (Table 1). Further analysis reveals that young firms were twice as likely as more established SMEs to require finance to buy premises and for staff development, whilst their main reason for requiring finance was for working capital.

As mentioned above, it has been argued that information asymmetry is particularly acute in younger SMEs and therefore a key part of the explanation as to why they have more difficulty than established SMEs in accessing finance. At this early stage information is limited and not always transparent so that finance providers are more wary of lending because of the greater uncertainty involved. Whereas within established businesses information is more efficiently transferred by, for example, an established track record and product branding, mechanisms not readily available to business start-ups. It is argued therefore that new and early stage SMEs possess a considerable informational advantage about the businesses vis-a-vis finance providers. Additionally, entrepreneurs seeking funding have an incentive to emphasise the strengths in a business proposal and to keep hidden what they know to be any flaws (de Meza, 2002). On the other hand, there is an

opposing line of argument that suggests that finance providers are likely to have a better idea of whether a new business is likely to be successful than the entrepreneur starting the business because of the experience they have derived from dealing with previous business proposals in similar sectors (Storey, 1994).

**Table 1: Comparison between new and older firms' access to finance in Scotland**

| During the previous year:       | <4 years |        | 4+ years |      | Total  |      |
|---------------------------------|----------|--------|----------|------|--------|------|
|                                 | Number   | %      | Number   | %    | Number | %    |
| 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

Source: ASBS (Scotland) 2006

**Table 2: Problems of accessing finance by age of firm in Scotland**

| During the previous year:          | <4 years |       | 4+ years |       | Total  |       |
|------------------------------------|----------|-------|----------|-------|--------|-------|
|                                    | Number   | %     | Number   | %     | Number | %     |
| 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       | 100.0 | 261      | 100.0 | 296    | 100.0 |

Source: ASBS (Scotland) 2006

There is relatively little support for the information asymmetry argument relating to young firms from the Scotland study. From the perspective of entrepreneurs themselves, the main reason why start-up and early stage businesses have problems in accessing external finance is the absence of a track record, combined with the difficulty of raising the level of collateral and personal security required by lenders. This makes it especially difficult for this group of SMEs and owners to raise external finance. Since most banks segment the SME market either by size of turnover or by the size of funding proposals, the treatment of

applications from micro and small firms tends to rely more heavily on credit scoring methods than those from larger firms where there is a greater element of bank manager discretion and flexibility. This can place younger SMEs at a disadvantage, especially where there is a lack of credit history and trading track record.

Further evidence relating specifically to young entrepreneurs starting businesses in Scotland comes from the Princes Scottish Youth Business Trust (PSYBT), a national agency that supports entrepreneurs through advice and some limited loan and grant finance. This showed that very few (about 5 per cent) young entrepreneurs succeed in getting any support from commercial banks. Moreover, the PSYBT found that perceived difficulties in accessing finance were also found to be responsible for the finance gap among this group of entrepreneurs since 70 per cent of young entrepreneurs 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 so there was little point in trying (Scottish Enterprise, 2007). This is an indication therefore of a strong 'discouraged borrower effect' amongst young entrepreneurs.

### **3.2 Manufacturing SMEs**

A striking finding of both the Scotland and London studies is that manufacturing SMEs were more likely to experience problems in accessing finance than SMEs in other sectors. In the case of the Scottish evidence, manufacturing SMEs experienced particular problems accessing bank finance. As Table 3 shows, whereas manufacturing SMEs represented 19 per cent of SMEs taking part in the ASBS (Scotland), they comprised 46 per cent of those reporting problems accessing bank finance. Manufacturing SMEs were twice as likely to experience problems compared with SMEs in other sectors. The Scottish manufacturing SMEs were typically seeking external finance for new product and market development, upgrading plant and machinery, and in a few cases to finance acquisitions. The owner-managers of manufacturing SMEs frequently criticised the banks for being risk averse and bank lending officers for lacking the necessary sectoral and technical knowledge, indicating that information asymmetry can be an issue in the case of some more specialist manufacturing SMEs.

These findings are largely confirmed by the London study. Manufacturing SMEs were significantly more likely to approach external sources for finance in the 12 months prior to the 2007 London Annual Business Survey (LABS) than businesses in other sectors (35 per cent of all manufacturing businesses compared to 20 per cent of all businesses) (Table 4). At the same time, manufacturing SMEs were also more likely to report problems in accessing finance, with 29 per cent of them identifying a problem compared with 12 per cent of all businesses. Furthermore, manufacturing SMEs were more likely to indicate that the difficulties in accessing finance had been a constraint on investment in the previous 12 months. Manufacturing SMEs were generally looking for larger amounts of finance (a median of £70,000 compared with £45,000 across all sectors) and, as the following examples illustrate, encountered difficulties because of there being insufficient equity in the business or other forms of collateral. For example, the owner-manager of a company manufacturing cleaning materials needed £500,000 for investment including extending their premises, but was turned down by the bank because of insufficient collateral. Similarly, the owner of a petrochemicals company that traded internationally required £350,000 to purchase new equipment and to develop new product lines, but was also turned down by the bank because there was insufficient equity in the business to guarantee the loan.

**Table 3: Problems accessing bank finance by sector amongst Scottish SMEs**

|                       | <b>SMEs reporting difficulties with bank finance</b> |              | <b>ASBS (Scotland) 2006</b> |              |
|-----------------------|--|--------------|-----------------------------|--------------|
|                       | Number   | %            | Number                      | %            |
| 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           |
| <b>Total</b>          | <b>39</b>  | <b>100.0</b> | <b>1014</b>                 | <b>100.0</b> |

Source: ASBS (Scotland) 2006

**Table 4: Proportion of London Businesses accessing external finance by sector**

|                                  | <b>Number</b> | <b>Percentage approaching external sources</b> | <b>Percentage experiencing problems</b> |
|----------------------------------|---------------|--|---|
| Manufacturing                    | 332           | 35%  | 29%                                     |
| Construction                     | 378           | 22%  | 14%                                     |
| Wholesale & retail               | 894           | 18%  | 12%                                     |
| Hotels & restaurants             | 502           | 16%  | 9%                                      |
| Transport & communication        | 301           | 19%  | 16%                                     |
| Banking & finance                | 280           | 24%  | 19%                                     |
| Business & professional services | 1136          | 19%  | 11%                                     |
| Other                            | 704           | 22%  | 11%                                     |
| <b>All businesses</b>            | <b>4527</b>   | <b>20%</b>                                     | <b>12%</b>                              |

Source: London Annual Business Survey 2007

These findings from the Scotland and London studies are consistent with other recent research evidence relating to the UK. For example, a UK wide survey of financing of SMEs (CBR 2008) found that firstly there was an increasing demand from manufacturing SMEs for external finance which ran counter to that of SMEs in other sectors and that secondly manufacturing SMEs were less likely to be successful than their counterparts in other sectors.

Although only a small minority of SMEs in both the Scotland and London studies had been seeking equity or venture capital finance (2.7 per cent in Scotland and 3 per cent in London of those applying for external finance), there is some indication from both studies that there is a gap relating to smaller amounts of equity finance and that this was most likely to affect high growth SMEs in manufacturing. Thus interviewed venture capital fund managers in the London study thought there was an equity gap extending up to investments in the £2–3 million range as a result of institutionally backed private sector venture capital funds having moved ‘up market’ to above £2 million or higher. This problem is illustrated by one of the interviewed London SMEs, a fast growing publishing consumer magazine company, which was seeking £500,000 of venture capital to finance an innovation that would take the brand into the digital arena as well as the acquisition of another company. The owner indicated that they were unable to attract venture capital finance because the amount they were seeking was too small compared to the venture capital firms minimum threshold of £2 million.

### 3.3 Women owned SMEs

Both the Scotland and London studies provide evidence to indicate that female entrepreneurs are more likely to experience difficulties in accessing external finance than their male counterparts. Also, the studies indicate that much of this can be attributed to certain perceived difficulties resulting in them being discouraged from applying to external sources, particularly the banks.

The Scottish study shows that businesses where women were the majority owners were more likely (significant at beyond the 0.01 level) to identify problems in accessing finance than their male owned counterparts, including problems in accessing bank finance (Table 5). In fact, a markedly higher proportion (43 per cent) of those firms encountering problems accessing bank finance were majority women owned compared with those having problems with other finance sources (14 per cent).

**Table 5: Comparison between men and women owned firms’ Access to Finance in Scotland**

| During the previous year        | Women  |        | Men    |       | Total  |       |
|---------------------------------|--------|--------|--------|-------|--------|-------|
|                                 | Number | %      | Number | %     | Number | %     |
| Tried to access finance         | 46     | 26.4   | 245    | 30.6  | 291    | 29.8  |
| Problems accessing finance      | 20     | 11.5** | 49     | 6.1   | 69     | 7.1   |
| Bank finance sought             | 30     | 17.3   | 158    | 19.7  | 188    | 19.3  |
| Problems accessing bank finance | 15     | 8.6*   | 20     | 2.5   | 35     | 3.6   |
| Total                           | 174    | 100.0  | 801    | 100.0 | 975    | 100.0 |

Note: \* significant at beyond .05 level

\*\* significant at beyond .01 level

Source: ASBS (Scotland) 2006

In the London study, businesses that were majority owned by women were less likely to approach external sources for investment over the 12 months prior to the survey (14% compared with 23% of majority male and 50:50 male/female owned) (Table 6). They were

less likely to approach banks than their majority male owned counterparts (65% of those approaching external sources compared with 75%). However, they were significantly more likely to approach loan funds (11% compared to 3%) and grants (4% compared to 1%).

**Table 6: Proportion of London businesses accessing external finance by gender of ownership**

|                   | <b>Number</b> | <b>Percentage approaching external sources</b> | <b>Percentage experiencing problems</b> |
|-------------------|---------------|--|---|
| Majority female   | 463           | 14%  | 9%                                      |
| 50:50 Male/female | 617           | 23%  | 14%                                     |
| Majority male     | 2384          | 23%  | 14%                                     |
| All businesses    | 4527          | 20%  | 12%                                     |

Note: 1063 businesses did not provide gender data

Source: London Annual Business Survey 2007

In terms of the nature of the access to finance problems that they identified, the most common difficulties identified by women owned businesses were: (i) a lack of advice about options/finance sources available (45% of those experiencing problems); (ii) a lack of asset collateral to guarantee loans (41%); and (iii) lending organisations not understanding the needs of the business (41%). Interestingly, a greater proportion of majority owned female businesses identified lack of advice as a problem compared with majority male owned businesses (45% compared with 35%).

As to reasons for not applying for external finance, majority female owned businesses were much more likely to feel that they would be turned down if they applied for finance because they were not profitable enough compared with their majority male counterparts (32% compared to 9%). They were also more likely to think that their poor credit history would be a factor (16% compared with 5%).

This evidence is largely consistent with what other researchers have said about women entrepreneurs being more likely to be discouraged borrowers than men (Roper and Scott, 2007). For example, a large UK wide survey of SME financial needs found that female-led businesses were more likely to feel discouraged or reluctant to approach external sources (CBR, 2008). A study of potential entrepreneurs found that they are more likely to be pessimistic than men in raising money to start business (Allinson et al., 2005) whilst Marlow and Carter (2006) found that debt aversion was constraining many women from starting businesses. Women have been found to encounter credibility problems when dealing with banks as well as lacking knowledge of available sources of finance and how to go about accessing them (Carter et al., 2001). They have also been found to be concerned about the extent to which bank lending officers are even-handed in their treatment of clients (Wilson et al., 2007). Browne et al. (2004) suggest that female entrepreneurs are also handicapped by their lack of experience in business and financial services, many of them having had careers in marketing and human resources previously.

However, these 'reputational effects' are only part of the explanation for the difficulties that women entrepreneurs face as it has been suggested that it also reflects the nature of the businesses that many women run. They tend to operate businesses which are low tech micro enterprises in the personal service sectors, located in crowded sectors with limited growth potential, operated on part-time basis, and having low equity (Marlow and Watson, 2006). For these reasons many women-led businesses have less need of accessing external finance. The financial guarantees required for external financing may be beyond

the scope of most women's personal assets and credit track record (Carter et al, 2001).

### 3.4 Black and minority ethnic businesses (BMEBs)

There is clear evidence from the London study that some of the greatest difficulties in accessing external finance are experienced by BMEBs, and particularly those owned by Black African and Caribbean entrepreneurs. First, the LABS 2007 data indicates that BMEBs had a greater need of external finance than White owned businesses since a significantly higher proportion of Black and Asian owned businesses (44 per cent and 30 per cent respectively) approached external sources for investment and other finance in the 12 months prior to the survey compared to White owned businesses (19 per cent) (Table 7) Second, a higher proportion of Black owned businesses seeking external funding approached banks for finance (87 per cent of them) compared to White owned (72 per cent) and Asian owned businesses (74 per cent). However, although a greater proportion of BMEBs approached banks for finance, they were significantly more likely to have their applications rejected. Whilst 74 per cent of White owned businesses were successful in obtaining bank finance, this compared with just 29 per cent of Black owned business and 57 per cent of Asian owned businesses.

And third, given their lower success in applying for debt finance, there can be little surprise that BMEBs were also more likely to report problems in accessing external finance than their White counterparts (Table 7). Thirty-two per cent of Black owned businesses reported having problems compared to 21 per cent of Asian owned businesses and 11 per cent of White owned businesses. Further analysis revealed that Black owned businesses were much more likely to consider access to finance as an issue posing a major problem to the business (27 per cent of Black businesses compared to 7 per cent of White owned businesses and 11 per cent of Asian owned businesses). According to the surveyed owner-managers themselves, the main problems that Black owned businesses experienced in accessing external finance in the 12 months prior to the study related to lack of asset collateral to guarantee a loan (65 per cent of those businesses experiencing problems), lending organisations not understanding the needs of the business (63 per cent) and not being able to obtain a large enough amount of funding (60 per cent).

**Table 7: Proportion of London businesses accessing external finance by ethnic group of ownership**

|                | <b>Number</b> | <b>Percentage approaching external sources</b> | <b>Percentage experiencing problems</b> |
|----------------|---------------|--|---|
| White          | 2918          | 19%  | 11%                                     |
| Black          | 138           | 44%  | 32%                                     |
| Asian          | 405           | 30%  | 21%                                     |
| Other          | 134           | 18%  | 12%                                     |
| All businesses | 4527          | 20%  | 12%                                     |

Note: 932 businesses did not provide ethnicity data  
Source: London Annual Business Survey 2007

These findings are consistent with the evidence from a major UK wide survey that found that the proportion of BMEBs reporting difficulties in obtaining finance from their first source was twice that of non-BME businesses, with Afro-Caribbean owned businesses

facing a significantly higher rate of rejection (Fraser, 2005). Fraser's analysis concluded that these differences were explained by risk factors (e.g. their lack of credit worthiness) and financial relationships (e.g. higher rates of missed debt repayments and unauthorised overdraft borrowing) rather than ethnic discrimination.

However, other studies have suggested that there is perceived discrimination amongst BME entrepreneurs. For example, a study of the business issues and support needs of African and Caribbean business owners in London revealed that many of the interviewed owner managers had a perception of negative stereotyping by bank managers (CEEDR 2000). This is supported by evidence from Scotland where perceived institutional discrimination appeared to be a factor leading to reluctance on the part of BME entrepreneurs to approach external sources of finance (Deakins et al., 2005). In addition, the move towards centralised decision-making in some banks could militate against building good relationships with BMEBs. It has also been suggested that the tendency for BME businesses to be concentrated in deprived areas contributes to their difficulties in accessing finance, given the tendency for some lenders to withhold finance from neighbourhoods considered to be high economic risk (National Employment Panel, 2005).

Other reasons highlighted in the literature for the finance gap effecting BMEBs are cultural and language barriers. Thus Ram et al. (2001) found that there were strong feelings against using banks amongst the BMEBs they studied, based on cultural and religious practices as well as concerns about language barriers resulting from the limited employment of ethnic minority staff by the banks themselves. However, the counter-argument against the finance gap hypothesis among this group of entrepreneurs is that many BMEBs are in low value added and over crowded sectors such as retailing, wholesale, restaurants and other consumer services (Ram et al., 2001). In addition, the Bank of England (1999) study concluded that the problems of accessing finance by ethnic minority entrepreneurs were due to their concentration in sectors where there is intense competition and low business survival rates. Although the bank managers interviewed in the Scotland and London studies claimed that they did not exclude any particular sectors, it was clear that entrepreneurs in sectors characterised by intense competition will 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.

#### **4. CONCLUSIONS**

Because of market imperfections and the various factors, both perceived and real, that can stand in the way of businesses being able to access finance from different sources, it is arguably more useful to identify finance gaps (i.e. where there is clearly unmet demand for finance) than to try and demonstrate categorically whether or not market failure exists. This paper has set out to investigate finance gaps that arise from the relationship between entrepreneurs and SME owner-managers on the one hand and finance providers on the other. In doing so, it has been concerned with exploring whether the difficulties that certain types of SME face in accessing finance are caused by two issues that feature prominently in the literature, namely information asymmetry and reputational effects. This has been done in relation to two recent studies of SME access to finance in the UK undertaken by the authors, one in Scotland and the other in London, both of which have used a methodology incorporating a demand-side and a supply-side perspective on the research problem.

Although the majority of SMEs appear to have little difficulty in obtaining the finance that they require from external sources, both studies showed a significant minority of SMEs encountering difficulties. In itself of course, this does not indicate market failure, since these

difficulties may arise because of fundamental weaknesses in the business case being presented for funding rather than because of sub-optimal lending practices by banks and other funding providers. Indeed, the evidence from the Scotland and London studies together with other research evidence does indicate that much of the lack of success in obtaining finance stems from inadequacies in the business case presented to finance providers, with many of the businesses experiencing difficulties operating in sectors where they face intense competition, low profitability and limited growth prospects.

At the same time, however, the research has revealed instances of finance gaps that have contributed to some potentially viable business proposals not being funded. This was found to apply to some manufacturing SMEs that were seeking finance for new product and market development and investing in upgrading plant and machinery, with their owner-managers criticising the banks for being over-cautious and risk averse and unable to understand the nature of their business. There is some indication that information asymmetry provides part of the explanation in these instances. There is less support for the suggestion that information asymmetry explains why a relatively high proportion of younger SMEs encounter problems accessing external finance since the evidence from the two studies suggests that the difficulties are more likely to arise because of the lack of a trading history and the difficulties of providing the level of collateral and financial security that finance providers look for. There is however some indication of entrepreneurs lacking knowledge of available finance sources and how to go about applying to them, this being particularly evident amongst some women entrepreneurs. Also, a lack of confidence in approaching finance providers has also been found to contribute to the lower demand from women-led businesses, this being an example of the 'discouraged borrower effect'. There are clearly a number of interrelated factors that explain why BMEBs, and Black businesses in particular, struggle to obtain external finance, although research suggests that reputational effects such as perceived if not actual discrimination are part of the explanation.

Clearly a key question at the present time concerns the impact of the global financial situation and economic downturn on the ability of SMEs to obtain the finance that they require from external sources. The findings presented in this paper relate to more favourable economic conditions since the Scotland study was carried out in 2007, prior to the onset of the credit crunch within the UK, and although the London study was undertaken in 2008, much of the survey data that it used related to 2007. Having said this, it was possible to incorporate some questions on the effects of the credit crunch in the interviews undertaken with a sample of London-based SME owner-managers, accountants, business advisors, and various finance providers between August and October 2008.

Whilst only a few SME owner-managers could give specific details about how their ability to raise finance had been affected, about a third of them expected their ability to raise finance to be adversely affected in terms of the cost of borrowing and the tightening of the lending criteria by finance providers. Concerns were also expressed about the increasing reluctance of lenders to fund more risky sectors and about the effect of falling property values on their ability to provide the required security. There was also some indication that demand was beginning to shift away from investment and growth finance towards recovery/rescue finance (particularly in the construction and property related sectors).

On the supply-side, the commercial banks reported a decline in the demand for loan finance from SMEs (in one case a 15 per cent fall in the year to August 2008). In terms of debt finance, it was reported that banks were favouring larger funding proposals as well as concentrating on those existing SMEs with a good history of managing debt, making it more difficult for start-up and early stage businesses to obtain funding. It was generally thought that bank lending criteria were being tightened through stiffer credit scores and loan to value ratios, with the market for smaller business loans suffering most. With regards to equity

finance, most interviewees considered that the credit crunch would have an adverse effect as less funds became available, leading to a widening equity gap for smaller amounts (below £2 million). There was also some evidence that business angels were retrenching and using their capital to support current investments and avoiding new deals.

Overall, therefore, it looks as if the impact of the credit crunch in the UK will be to exacerbate the funding gaps experienced by those types of SME that were already facing the greatest difficulties in raising external finance, namely start-ups and early stage businesses, manufacturing SMEs, and BMEBs. It remains to be seen how effective the recent actions taken by the UK Government (e.g. the introduction of the new Enterprise Finance Guarantee to try to stimulate lending to small firms) will be in closing these finance gaps.

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