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Improving Finance for UK Small and Medium-Sized Businesses

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Introduction

The GPI industrial policy programme for 2011/2012 is focused on finding ways to address key restraints to growth faced by industry in the UK. The aim is to be able to make constructive and well researched recommendations on measures that will aid UK economic recovery.

Although, not traditionally regarded as an industry sector, small and medium sized companies (SMEs) play a key role in the economy, and could potentially play a key role in economic recovery. One important barrier to this happening is the difficulty many SMEs face in obtaining financial support.

To help understand this problem, GPI has undertaken a short study outlining the significance of the sector, some of the approaches to the provision of finance and their shortcomings, and has identified a number of measures that could lead to improvements.

This study is based upon desk research and refers to published research carried out in the UK and elsewhere. As a next step, this report will be discussed with industry representatives with a view to validating the measures proposed. If you are reading this on the web, please address any comments to r.dowler@gpilondon.com.

The Importance of Small and Medium Enterprises

SMEs fulfill two roles in the economy: their flexibility allows them to bring unused resources into the formal economy and new companies are a major source of new business ideas that create economic growth. These two roles are exceptionally important in the present economic climate. At this point in the economic cycle the need to bring spare capacity back into use is more than ever, small businesses fulfill this function. Secondly rebalancing the economy away from financial services and returning to growth will require new and productive business ideas. The 2011 HSBC Future of Business Report found that 62% of business leaders believe Britain will stand for 'innovation and entrepreneurship' in the future up from 46% in 2009.

SMEs are an important part of the labour market. They provide 59% of the United Kingdom's private sector employment, around 46.5% of total employment, just fewer than 13 million people.[1]

They are able to bring currently unused resources back into productive work in a way that large businesses do not. The price sensitivity of SMEs and the direct supervision that management can provide gives them a greater incentive than large firms to hire workers who are currently unemployed or with few formal qualifications. Around 10% of the workforce employed in SMEs have no formal qualifications while just 5% of workers in large firms do so.[2] What's more those who have been made redundant are at least theoretically as able as those in full time work to start their own business when they cannot find a job.

As a response to being made redundant many individuals will choose to do more informal work, such as looking after neighbours' children or painting or decorating for friends. This work will often be casual and unregistered. Country comparison studies find that SMEs and the informal sector usually contribute around 65-70% of GDP across all levels of development.[3]

If formally unemployed individuals are successful they may choose to form a business and profesionalise these services. The SME sector brings these unused or informal resources into the formal economy. Coming out of a recession this function is more important than ever.

Employee relations in small firms tend to be better than large firms; 67% of employees in small business 'strongly agree' that managers treat them fairly compared to 53% in large firms.[4]

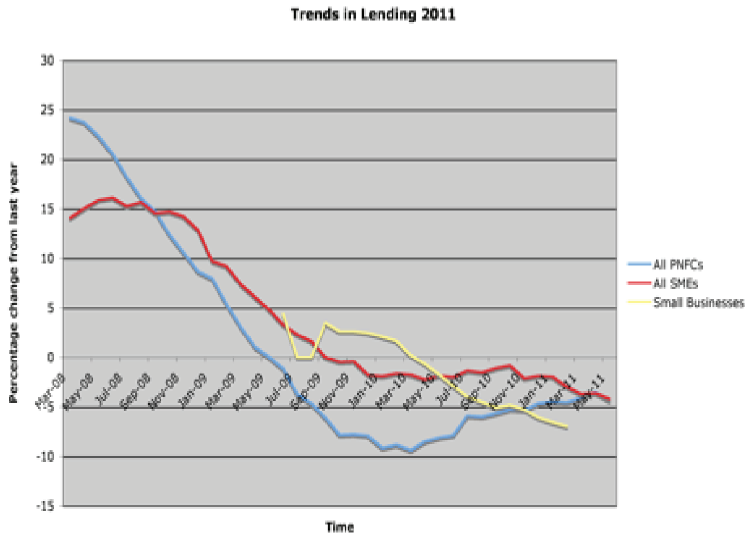
While the SME sector creates a surprising number of jobs it also destroys a significant number. SMEs are much more likely to collapse than larger businesses. This shouldn't be a cause for concern. Small businesses resemble Josef Schumpeter's vision of creative destruction, new more efficient entrants come in and replace firms which are relatively inefficient. Through this process small businesses promote growth. A study by T. Beck and A. Demigruc-Kunt of small businesses in Italy and the UK found that Italy had high barriers to entry, small firms face high costs to entering the marketplace. These barriers ensure that Italy has fewer, older and inefficient firms. In Britain where barriers to entry are low, new entrants are smaller but grow faster. Competition is alive and well for small businesses and ensures that only the best survive and contribute to growth.[5]

In 2000 the company Plastic Logic emerged from Cambridge Universities research laboratories after pioneering research into plastronics, electronic systems printed on to plastic. In 2008 it opened a commercial factory in Dresden, Germany and will soon open a second near Moscow. Intercytex based in Manchester is a pioneer in regenerative medicine, focusing on the development of skin rejuvenation technology that is now being trialled by the Pentagon.[6] Small companies like these build on the strong tradition of research in the UK and show how the commercial applications of high tech innovation will often be spread by small businesses.

SMEs employ the majority of private sector workers in the sectors of the British economy that have grown the most since the 80s, Human Health and Social Work (74.8%), Professional, Scientific and Technical Activities (74.8%) and Education (84.1%) [footnote:ONS Labour Force Survey (2010)]. With an aging population, public sector funding cuts, changes in funding for University study and increased demand from the Far East for a British education, the private sector is likely to experience increased demand in Health Care and Education. While the evidence of the last few decades suggests that an increasing reliance on technology and expertise worldwide means that Professional Scientific and Technical activities will continue to be a growing sector.

SMEs represent a realistic and desirable vision of the future of the UK economy as a centre for pioneers and entrepreneurs coexisting with the low-cost manufacturing of the far east. However, small businesses face an unfortunate economic environment in the short term that may constrain their development in the long term. Financial crises hit small businesses hard; both demand and liquidity are simultaneously hit.

The ability to get finance is reduced when cash flow is low already. Risk averse banks are much more likely to stop lending to small businesses than large businesses. Data from the bank of England demonstrates how lending to small businesses has collapsed since 2008.



Small businesses use finance to start up, to fund growth and to maintain cash-flow. These needs are all the more vital during a recession but when credit dries up businesses can't manage and viable businesses will go under. The Federation of Small Businesses reports that the biggest barriers to growth that owners of small businesses report are uncertain market conditions, inadequate cash-flow and lack of market capital. The need to improve the finance to SMEs is evident and desirable.

Background: Project Merlin

Lending to SMEs has been drastically effected by the recession. Data from the Bank of England reveals that lending to small businesses had fallen by just under 7% in the year before February 2011. The Bank of England offers two explanations for this fact; while certain Small Businesses were using the opportunity to deleverage, others were unable to access credit. Larger businesses were able to access bond and equity markets, while this option wasn't as open to smaller businesses and commercial lending has fallen dramatically.

In February of 2011 the Treasury announced 'Project Merlin', an agreement with four major high street banks; Barclays, Lloyds Banking Group, the Royal Bank of Scotland and HSBC. These banks committed to make £190bn of credit available to business in 2011, £76bn was intended for small business (40%). Responsibility for monitoring whether the funds are available falls to the Bank of England. Successful achievement of these targets is one of the measures used to assess the remuneration of chief executives.[7]

The interim reports released in August showed that the banks are on track to meet these targets with just under 50% of the amount intended to be lent to Small businesses already called.[8] However this data has been criticised for being misleading and unclear. All banks except for RBS include data for undrawn overdraft facilities with their lending and banks characterise Small and Medium enterprises differently. The Bank of England qualifies the statistics for project Merlin by saying that "These data are not collected under the Bank of England's statistical code of practice and definitions of data vary across banks."

In addition to these targets, Project Merlin is intended to make the procedures of the banks more transparent and much easier for small and medium enterprises to deal with. These measures include publishing the minimum standards that Small and Medium Businesses have to meet, 'supporting' mentors for small businesses and improving customer information generally.

Project Merlin has been criticised on several grounds, among these one that is quite reasonable is that the targets are for gross lending rather than net lending. When it includes the amount of credit that banks have called in, the amount of lending is much lower. The Bank of England's Trends in Lending report found that net lending to UK businesses decreased over the second quarter of the year.[9] Secondly, Merlin's targets only look at the quantity of credit rather than the price at which it was provided, average rates to small businesses were five percentage points higher than the base rate.

The Bank of England's most recent trends in lending report, states that lending to SMEs has contracted over the last quarter by 3.7%. The table below, using information gathered by ICM for the Federation of Small Businesses and summarises the current sources of financing used by SMEs:

Source of Finance: Percentage of firms using source:

Source of Finance:	Percentage of Firms using Source
Bank Overdraft	28%
Own Savings	24%
Retained Profits	24%
Bank Loan (secured)	11%
Company Credit Card	7%
Personal Credit Card	7%
Family	7%
Supplier Credit	5%
Bank Loan (unsecured)	6%
Factoring/Invoice Discounting	3%
Leasing	3%
Other Business/ Employmeny	3%
Second Mortgage	3%
None of these	27%

Most SMEs are at present turning to alternative sources of finance to fund their business than bank loans. The evidence suggests that Project Merlin is not working and a new strategy is required.

A Framework For Considering the Issue

A conceptual framework developed by Allen Berger of Indiana University and Gregory Udell of the World Bank is a helpful tool in formulating a new strategy of improving lending to small and medium businesses. In this framework banks use 'lending technologies' to underwrite and gather information about loans to businesses. Some of these technologies favour small businesses, while others can serve to discriminate against them. The exact mix of lending technologies deployed is determined by the structure of the market and the infrastructure that is available.

The essential problem of lending to small businesses is gathering information about them. Gathering information is time consuming and costly for both the management and the bank and with small loans this cost can remove the benefit of the loan or increase its price. Technologies that improve this process are more likely to benefit small businesses.

This framework begins by setting out the different lending technologies. These are essentially strategies that the banks choose in order to maximise profit. The profit maximising strategy is determined by the 'lending infrastructure', the state of the market, laws, regulations, tax and even society itself. Most of the studies conducted in this area date from before the financial crisis and their findings need to be seen in that context.

Berger and Udell separate lending technologies into two categories: Relationship and Transaction lending. Transaction lending is the most common form and depends upon hard information about the state of the business, relationship lending is based on 'soft' information gathered through personal contact between the lender and recipient.

Berger and Udell identify six different types of transaction lending:[10]

1. Financial Statement Lending
Financial statement lending is fairly self-explanatory, lenders examine the borrower's financial statements. For this to work it must be the case that the borrower has readily available, informative financial statements prepared to reputable accounting standards. Any contract may contain a mixture of personal and collateral guarantees but the lender expects the cash flow of the SME to fund repayment.

2. Small Business Credit Scoring
Small Business Credit Scoring is similar to financial statement lending but information about the owner is included alongside information about the business. This generates a score which is used to assess the credit worthiness of the business. Because it includes data about the owner which is gathered by consumer credit bureaus small businesses do not have to pay the fixed costs associated with gathering information about the business.

3. Asset Based Lending
Financial institutions address the opacity problem by lending against assets and not cash flow. Lending is secured against accounts receivable or inventory. The value of collateral is linked to the size of credit available.

4. Factoring
Under factoring the "lender" purchases the assets. Factoring focuses on the value of an underlying asset, rather than the overall value/risk of the firm. Factoring is similar to asset-based lending except that it only covers accounts receivable rather than inventory and that the 'lender' buys the assets.

This means that the 'lender' also provides a credit service and a collections service as well as financing. This is an additional overhead and the factoring process can interfere with customer relationships, especially where credit terms become more onerous.

5. Fixed Asset Based Lending
Fixed asset based lending is similar to asset based lending but the underlying assets are of a different type. They are long lived and not sold in the course of business (e.g. equipment, motor vehicles or real estate). The assets are pledged to the lender as collateral. This has a very different underwriting procedure to asset based lending. It is also much cheaper to monitor as there is typically a repayment schedule organised in advance. However the amount of liquidity that can be raised by this method is limited and some companies, such as software companies have, no suitable fixed assets.

6. Leasing
Fixed Assets are sold to the 'leasor', analogous to factoring but for a different type of asset.

Berger and Udell's purpose in highlighting these different types of transaction technology is to show that not all of them work against small businesses. While financial statement lending is difficult for small businesses others such as asset based lending and factoring work for relatively opaque businesses.

Relationship Lending is the other broad family of lending. Information is gathered using 'soft information' and personal contact with the loan officer and through observation of the SME's performance in its relationship with a bank. The bank can also gather information through the firm's customers, suppliers and neighbouring businesses. This information is not easily verified or transmitted to others. Trade Credit is labeled as 'mixed' technology. This form of credit occurs when manufacturers, suppliers and customers supply de facto loans by allowing the business to defer payment. Udell and Berger are unclear about how best to characterise trade credit in that it depends upon a long term relationship with suppliers and customers yet it depends upon hard information that is used to underwrite and support this credit. Mutual trust is an important part of the process.

The lending technologies that banks choose depends upon the incentives they face. The cost of gathering certain types of information and the mix of risk and rewards are in part determined by the wider economy. The following paragraphs survey the literature and economic theory on the impact of different features of the economy on the extent of lending to Small and Medium Enterprises.

Market Structure: Size of institutions
The standard theory is that large institutions have a comparative advantage in transactions lending and small institutions have an advantage in relationship lending. Large institutions are able to bear the costs of setting up systems of processing hard information quite easily but are unable to quantify and transmit soft information through large organisations. In small institutions with fewer levels of management, soft information is more easily available to senior management.

A wealth of empirical data (Haynes, Ou, and Berney 1999, Cole, Goldberg and White 2004, Scott 2004, Berger, Miller, Petersen, Rajan, and Stein 2005) suggests that large financial institutions tend to lend to larger, older SMEs with stronger financial ratios while small institutions rely more on soft information and lend to SMEs with which they have stronger relationships (same papers as before). This is consistent with an advantage for large banks in using financial statement lending as they are dealing with more transparent firms.

Much of the evidence also seems to suggest that larger banks offer lower interest rates to small businesses than small banks. This is consistent with the idea that large banks lend to less risky, less opaque small businesses. One study (Does market size structure affect competition? The case of small business lending – Allen Berger, Richard Rosen, Gregory Udell) shows that the likelihood that a firm gets credit from a small bank versus a large bank is proportional to the market presence of small banks versus large banks. Secondly this study finds that the presence of a large bank in a local area can force down the risk premium associated with lending to a small business irrespective of the size of the bank. This evidence from the US suggests that banks set prices due to competition and not due to their own size and the quantity of loans to SMEs is not determined by the size of a bank. However the US had a much more diverse banking sector with a much lower share of total deposits owned by large banks than any other country at the time of this study and these results may not apply to modern Britain.

State vs. Market:

The evidence and theory of the impact of state owned banks is mixed. The state is large and centralised, and so would be expected to have similar problems to large banks in lending to SMEs but often the state may be expected to subsidise small businesses that large banks would reject. The state may be expected to be more inefficient due to lack of market pressure and to crowd out private investment. A comprehensive study by La Porta, Lopez de Silanes and Shleifer in 2002 found that unfavourable macroeconomic conditions and less developed financial systems are associated with large shares of state owned banks. The direction of causality however is still uncertain as it may be the case that state involvement in the financial sector is a government response to poor macroeconomic conditions in some circumstances while in others it may provoke sluggish development of financial institutions. It may also be indicative of a political culture in a country that has little regard for the private sector. In some countries corruption is quite problematic and state finance is used to reward political friends (Sapienza, 1999).

Robert Townsend and Jacob Yaron (2001) write a rare dissenting paper that examines the Thai government's Bank for Agriculture and Agricultural Cooperatives during the Asian financial crisis of the 1990s and found that it almost doubled it's client base as well as lending at rates 1 or 2% lower than commercial rates. This was accompanied by stability and relatively little dependence on subsidy. This success is primarily identified as having its roots in an effective corporate culture, a strong branch network and excellent relationships with its clientele. The subsidised lending in the early stages of the banks development was replaced by lending out the savings of those who had originally benefited from its loans, suggesting that strong relationships with Small Businesses can be mutally beneficent.

Market Power:

There are two well-known results from economic theory that should guide us when examining the impact of market power on lending to SMEs. Firstly that market power reduces the amount of a good supplied in order to increase the price and inflate profits. The second is that as Rothschild and Stiglitz (1976) demonstrated it is theoretically possible that monopolies can do better than competitive firms in situations of incomplete information as they can subsidise risky businesses in order to discover those which are less risky. This second result may be compounded in the case of SMEs as monopolies may offer loss-making loans in the present in the expectation of future profits.

In general the empirical results reflect this uncertainty within economic theory, with some cross-country studies finding unfavourable results and others finding favourable results. It can be expected that there is an 'optimal' level of competition but discovering what this level is presents a herculean task to policy makers and researchers.

Information:
The presence of strong credible accounting firms and credit bureaus is extremely helpful in facilitating lending to small and medium enterprises especially through Small Business Credit Scoring. The theory behind this result is fairly obvious, better information leads to a more accurate knowledge of risk and banks are better able to judge which small businesses are credit worthy.

Legal:
Unsurprisingly, strong legal systems with protection for lenders, low levels of corruption and unambiguously defined property rights tend to have much higher levels of SME lending. The UK tends to do very well in this area ranking very low worldwide for corruption even within Europe with a strong legal environment.

Social Environment:
Empirical research and theory demonstrate that trust and social links between individuals improve access to credit. For example, finance to SMEs tends to be higher in countries in which only one language is spoken. Trust and reciprocal contact between business owners and those who can supply finance improves the efficacy of relationship lending.

Tax and Regulatory Environment:
The tax and regulatory environment directly affects the incentives and costs of types of lending. For this reasons it is perhaps the most useful of the governments' tools for controlling lending. Empirical research does not yield any general principles when it comes to taxation and regulation beyond the obvious: favourable taxation and regulation for technologies that favour SMEs lead to better funding for SMEs.

The recent Brumarck case represents a risk to lending for SMEs. In this case the Supreme Court determined that the Inland Revenue and former employees of a bankrupt company had prior claim to payments yet to be received rather than a bank which had accepted these assets as collateral.[11]

The legal principles and judgment behind this case are beyond the scope of this survey yet the economic impact is likely to be negative for SMEs. The case reduced the incentive and legal protections for firms that engage in the third of Udell and Berger's transaction technologies; asset based lending. This is one of the technologies that is likely to benefit small firms disproportionately. A reconsideration of the Brumarck case should be part of any policy aimed at relieving pressure on small businesses.

Possible Avenues of Research

This section identifies five possible measures that could help improve financing to the SME sector:

- A state funded development bank
- Increased competition in the financial sector
- Improved incentives for banks to try new lending technologies
- A fiscal stimulus aimed at SMEs
- Microfinance and Peer-to-peer Finance Initiatives

Development bank:
One option is for the government to offer loans to the private sector. The British government has access to more debt at a lower price than many SMEs and can sell this on at a mark-up to the SME sector. This was precisely the idea behind the Strategic Investment Fund launched in 2009. With a budget of £750m it was intended to lend not to SMEs but to 'strategic' businesses such as high tech and green manufacturing.

The Fond Strategique D'Investissement

(FSI) was a much larger French initiative that began work in November 2008. It is a public body that is designed to invest in French companies to encourage growth and competitiveness during the recession. The FSI has a budget of 20bn euros that is provided by its two shareholders, shareholders, the Caisse des Depots with a 51% stake and the government has a 49% stake. The Caisse des Depots was an initiative introduced by Napoleon to use private funds for long-term investment. The FSI's funds are managed by a board of seven people, four from government and three from the private sector. The board is composed of twenty people from the unions, MPs and business associations. The FSI is explicitly not nationalising companies but taking entrepreneurial risk. It invests for eight to ten years and seeks to do so in a way that benefits the company even upon the FSI's exit.

There exists a sizeable policy discussion concerned with how the FSI should use its funds. Whether its concern should be aimed at 'strategic' businesses or to pick champions. The CEO Gilles Michel argues that the fund is strategic rather than the companies it picks. However policy changes depending on the sector, the FSI is seeking to provide funds to 'green'the automotive sector. Fulfilling policy aims as well as giving the sector a competitive advantage.

The main challenge to the idea of a 'strategic investment fund' is the question of whether or not it serves any purpose. It is possible that these organisations are making loans that the private sector would make anyway. If the private sector cannot identify potentially profit making small businesses then there is no reason to assume that a state which is not subject to market pressure might be any better. The state may also use up the available liquidity itself and starve the private sector of capital.

The main difference between the state and banks is that it faces incentives that the banks lack. While this occasionally leads to poorer outcomes such as state banks lending to political friends it can be used positively if the bank has some measure of independence. For example, the market might neglect certain types of goods such as green technology which provides a benefit to the wider community. The state may be willing to forego a profit if certain companies provide benefits to the economy. This is the logic behind a strategic development bank. Attempting to fund the technologies that will improve the growth of the UK in the future. A similar justification does not work for a bank aimed at improving employment and funding SMEs.

A possible avenue for research is the possibility of two types of banks that disproportionately benefit SMEs but do not attempt to provide a subsidy or pick winners. These banks would perform two functions; the first would be to provide (or match) funding to new technology start-ups as the private sector may neglect the growth externality of research and development, the second would fund the provision of low-cost housing. While Britain is famously understocked with cheap housing the SME sector includes the majority of Britain's real estate businesses and small builders. Choosing local small construction firms to carry out the work and linking the amount of loans available to the price of housing would create an automatic stabiliser for this sector.

Setting up these two banks would improve SME funding, achieve other policy objective and avoid the pitfalls of attempting to pick winners, wasting subsidies on firms that are inefficient or crowding out private sector investment in viable businesses.

Introducing Competition:

The effects of competition on lending to SMEs is uncertain. Oligopolies can subsidise risky or small SMEs in order to extract high interest rates from larger companies or less risky SMEs. They can use their market power to provide low cost loans to start ups in the knowledge that they can extract monopoly profits from Yet it is also likely that they restrict the amount of loans available in order for the scarcity to increase their price. Further research into this topic is a necessity and may yield incredibly promising results. Project Merlin identifies five very large commercial banks together they enjoy 84% of the share in SME banking services.

This is at least a cause for some concern and it is imperative that its impact is investigated. It is likely that the Independent Commission of Banking chaired by Sir John Vickers will examine the impact of competition on the banking sector and when the report is published its implications for the SME sector should be a primary concern.

Adoption of new lending technologies: The Federation of Small Businesses reports that leasing and factoring are hardly used at all. Only 3% use each of these technologies. Leasing and factoring are identified by Udell and Berger as two technologies that benefit Small and Medium enterprises by not requiring much in the way of costly information gathering. If new factoring and leasing companies enter the market or existing ones extend the amount they are willing to lend or lower the price it is possible that the cash flow of Small and Medium Enterprise may be improved. Future research ought to examine if policy can be used to encourage the growth of these financial technologies.

Targeted stimulus:

A common economic criticism of the possibility of successful countercyclical stimulus is the spectre of Ricardian equivalence, the prospect of a debt funded stimulus being saved by the population in order to pay the taxes that will inevitably have to pay for it. However this is thought not to be a problem in a situation of constrained liquidity. The stimulus is essentially an inter-temporal transfer of funds from the future to the present, analogous to a loan. A targeted stimulus to the SME sector would be able to remove some of the financial problems they face. The second most common problem that SMEs identify after 'the recession' is cash flow but when all types of tax are taken into account half of all businesses describe tax as a major obstacle. A temporary tax cut on 'profit insensitive taxes' such as National Insurance would work to improve the prospects of the SME sector by providing liquidity and improving cash flow.

In addition, a paper by Kenshi Taketa and Gregory Udell provides evidence that improving a markets prospects can lead to improved liquidity. They analysed the role of trade credit in supply to firms during a Japanese credit crunch. They were interested in the possibility that trade credit is used as a substitute for more formal lending when it is unavailable. The paper examined the Japanese small business sector during the period 1990-2000 after the collapse of the housing market and the implementation of the Basel II capital requirements, which together led to a reduction in credit. Taketa and Udell founds that the volume of trade credit was positively related to the volume of other credit sources during a recession. In sectors where formal lending was high, so was trade credit. This did not last into the boom, commercial lending and trade credit moved in opposite directions.

There are a few possible explanations for this, the direction of causation is unclear. The lack of trade credit during a financial crisis could indicate to lenders that there is a great deal of uncertainty within the sector. When a supplier or consumer is willing to lend to a firm that could indicate that the firm has good future prospects. Or it could be the case that other sources of credit reduce the uncertainty for suppliers and consumers that they will be paid back. It could be due to increased demand for all types of credit in certain sectors. Whatever the case, this indicates the possibility of a credit multiplier. In times of recession both trade credit and other forms of lending simultaneously dry up. An increase in the demand for small businesses may lead to a greater positive impact than just the increase in demand as a more successful sector increases the level of lending between firms.

Keynes advocated countercyclical stimulus partly because it would not only increase demand but also improve investor and consumer confidence. The evidence from Japan suggests that this holds true for SMEs, when confidence is low liquidity dries up. A stimulus that improves confidence could have a more profound impact on Small and Medium Enterprises than first appears. Research in this area could be promising.

Microfinance and peer to peer finance: Microfinance has become something of a supposed silver bullet for developing economies. The problem they face is that despite the fact that the total gross revenue from delivering one hundred loans worth £1,000 does not differ greatly from one loan of £100,000, the costs are much higher for the former. This means that it is often unprofitable for banks to loan to poor people and small companies. Microfinance initiatives attempt to overcome this problem by running not-for-profit finance initiatives often run by their customers, NGOs, governments or Banks.

In the study African SMEs, Networks and Manufacturing Performance (2004), Tyler Biggs and Maju Kedia Shah describe how trust among ethnic subgroups in Sub Saharan Africa has created a network of informal financial activity. Within Sub Saharan Africa certain ethnic groups dominate some industries:

> "The Regional Program for Enterprise Development surveys show that ethnicity is a strong indicator of network activity in manufacturing. Ethnic minority groups, for example, business networks of Indian ethnicity concentrate in segments of light manufacturing and import/export trade. In Southern Africa, European business networks control much of the upstream activities in manufacturing and mining. And in West Africa, Lebanese business networks are heavily involved in import/export trade and parts of the wood industry. Across the region indigenous-African, ethnically based networks are found mainly in agricultural and natural resource activities – the Luo, in Kenya, are networked in the fishing industry, and the Ashanti, in Ghana in the Cocoa industry. African ethnically based networks can also be found in small-scale industrial activities, such as metal working, furniture, food-processing and clothing."

Firms overcome the lack of formal financial institutions by creating long term relationships and networks. Members socialise together and build a reputation in the group. Manufacturers, wholesalers and retailers develop a network externality. This externality allows members of the group to have much easier access to trade finance from one another. The network is self-reinforcing, bringing advantages to businesses in the sector and is only available to members of the ethnic group for this reason one ethnic group dominates a particular sector.

These networks do work to improve the finance of small businesses. Businesses that are part of the network are larger when they start. They find it easier to set up and overcome barriers to entry. They are more likely to receive credit from suppliers, own property and to receive loans from banks at their start up. Biggs and Shah found that firms that are part of the network have significantly higher productivity and tend to grow faster. These results are still significant after controlling for several other economic and sociological features of the firms such as the managers education, the size and age of the firm. However these results should not be taken as indicating that these networks are good for the overall economy. These networks set up a distinction between the insiders of the network and the outsiders. As Adam Smith said "People of the same trade seldom meet together, even for merriment and diversion, but the conversation ends in a conspiracy against the public." While those within the network gain access to finance and contacts these can create stable patterns of business with few new actors and little innovation.

The comparisons between SMEs with access to the network and those without does not imply that the network of SMEs leads to better economic outcomes but neither does it preclude the point. A similar example to that of sub-Saharan Africa is Silicon Valley in California, where a subculture of young, technologically savvy entrepreneurs were able to create a culture and networks that foisted innovation. There is a tension between the value of cooperation to the public good in lowering costs and improving efficiency and the exclusionary distinction it creates between those inside the network and those outside that can be damaging.

It may be more beneficial to apply these models to the relationship between savers and entrepreneurs than to members of the same trade. The current average rate of interest paid by SMEs is 6%, the best rate of interest offered on an ISA is 3.10% this represents an incentive for more savers to loan directly to SMEs. If a charity or government organisation could reduce this inequality they could encourage those with a small amount of capital to make small loans to small businesses. Some of the most iconic internet brands such as, Google, Amazon and Ebay have made their money from tracking consumer data and matching it to behavioural models. If we combine this idea with the rise of social networking then it may be possible to design an online service for Small and Medium Enterprises to access loans from their customers, suppliers and family. A small firm may be able to articulate its funding needs and attract funding from those with which it has built an existing social network.

Ebay represents something of a pioneer in this area. It facilitates transactions between individuals with reputation as a key commodity. If the legal issues of security for savers and enforcing contracts can be sufficiently addressed. A site could somehow fulfill the role of credit registry and a broker may represent an appealing decentralised solution to the problem, lending would combine the technologies of credit scoring and relationships to help SMEs. The lesson from the Thai agricultural cooperative bank and Sub Saharan Africa is that relationships are a key commodity in for Small businesses. The internet has revolutionised modern communication and may be a possible source of innovation for the banking sector in matching savers to borrowers.

Conclusions

This report is a brief survey of the problems of financing SMEs. The long-term solutions are challenging and require further research. Some comprehensive institutional changes are certainly required to make the environment better for SMEs during recessions and to build in contingencies. It has, nevertheless, been psooible to outline promising areas for future work on this topic and suggest why more needs to be done.

Two initial steps that could be taken immediately are:

- Firstly, it is important to examine whether or not the Brumark judgment can stand. This is a complication that SMEs could do without in the present circumstances and its economic impact is likely to be negative. While it may be the case that alternative sources of funding such as factoring and leasing will replace asset based lending this will take time and will only add to their present problems.
- Secondly, a National Insurance holiday would represent a useful short-term measure to improve the cashflow of SMEs.

The overall conclusion of this research is therefore that, despite the challenges, there are promising areas for certain and real benefits that could realistically be achieved.

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