White Paper No.8

EXECUTIVE SUMMARY
March 2014

(full paper link: http://enterpriseresearch.ac.uk/publications/erc-research-papers/)

BACK TO BORROWING? PERSPECTIVES ON THE 'ARC OF DISCOURAGEMENT'

Stuart Fraser*
Warwick Business School
Stuart.Fraser@wbs.ac.uk

*The qualitative research in this report was conducted by Shiona Davies and Richard Smith of BDRC Continental. Appendix 2 (case studies) and text/tables relating to the qualitative research presented in the main text were prepared by Shiona and Richard.

Why do discouraged borrowers (DBs) matter?

DBs are businesses which would like to borrow but which do not apply for bank finance (loans or overdrafts) because they either: i) felt they would be turned down ('indirectly discouraged'); or ii) they made informal enquiries but did not proceed with their application because the bank seemed reluctant to lend ('directly discouraged'). The report looks at businesses reporting any discouragement whilst noting differences between types of discouragement where apparent.

While the number varies over the economic cycle, estimates indicate there are approximately 173,000 DBs the majority of which, around 115,000, are indirectly discouraged. Although the number of DBs corresponds to less than 4% of the 4.8m SME population, and compares to 3.6m (75%) 'happy non seekers' (businesses which say they have no need for external finance), it is about the same as the number of businesses denied bank finance.

Some DBs will be rightly discouraged because the business is simply not viable. However, to address financial constraints, it may be important to help creditworthy DBs to obtain loans/overdrafts and assist DBs that are viable, but more suitable for non-bank finance, to find alternative finances.

What does a typical DB look like?

DBs tend to be smaller, younger and more risky businesses. The owners of DBs also tend to be less wealthy, have lower levels of education and less business experience. A typical DB in the UK: has sales below £250,000, business assets of £10,000; fewer than 10 employees; is less than 7.5 years old; has an average/above average risk rating; belongs to either the real estate/business services or construction sectors; is located in London, the West Midlands or East of England; and has an owner aged 31-50 with 15 or fewer years of experience and a personal wealth of around £100,000.

Why are there DBs?

What we already know about DBs is mainly confined to an understanding of the extent of discouragement and the characteristics of DBs. However we know much less about the reasons for discouragement.

In this context, a model is developed to move our understanding of the reasons for discouragement forward. Discouragement occurs when the perceived cost of making a loan application outweighs the perceived chances of the application being successful. The model allows us to disentangle factors that affect the perceived chances of making a successful loan application from factors that affect perceived application costs. This increased understanding of discouragement will help policy makers make more informed decisions about how to assist DBs.

Using a large sample of SMEs, estimates of the model suggest that DBs are especially prone to misperceptions – they significantly under-estimate their actual likelihood of making a successful loan application – and they face higher perceived loan application costs compared to other businesses. Dissatisfaction with banking relationships significantly reduces perceptions that applications will be successful (and hence increases discouragement). Smaller businesses are also less confident that their applications will be successful. On the other hand, awareness of the Lending Code/Principles improves perceptions (lowering discouragement) possibly by raising expectations about minimum service standards. Media coverage of bank lending appears, in this study, to have little impact on perceptions that applications will be successful. Businesses which have poorer credit ratings and/or problems with debt/cash-flow management are more likely to be discouraged because their actual chances of obtaining a loan are lower. Looking at the indirectly/directly discouraged separately did not significantly affect these findings.

Issues with the application process such as perceived security requirements and terms/conditions of borrowing significantly raise perceived application costs (and hence increase discouragement). Similarly, younger businesses find applying for loans more difficult/costly. Conversely proactive banking (approaching businesses about borrowing requirements) helps to lower perceived application costs (lowering discouragement). Also raising awareness of the Appeal Process makes applying seem more worthwhile, since the business is more aware that an initial rejection need not be the end of the story, thereby reducing discouragement. Again, these results are robust to looking at the different types of discouragement separately.

In-depth interviews with 25 DBs offer some deeper insights into the reasons for discouragement and what might help to improve the situation. The basis for discouragement, regardless of type, is the refusal of a loan or overdraft application in the past. However, this refusal tends to be more recent for the directly discouraged. A badly handled decline makes the experience worse increasing feelings of discouragement. In this respect, the belief is that the lending decision is all being done on computer models rather than an actual assessment of the business itself. There were also few examples of the bank offering or signposting to alternatives (apart from invoice discounting) or suggesting ways of being successful next time. Overall improvements in the quality of banking relationships are felt needed to improve perceptions. At the same time, few of the businesses were aware of lending support initiatives such as the Appeals Process.

However there is a feeling that business support groups have a role, as a 'trusted voice', in helping businesses become more aware of the help and support available to them.

By how much might discouragement be reduced by addressing bank/business related issues?

Scenario analysis with the model suggests that fully addressing bank issues associated with discouragement (improving satisfaction rates, raising awareness of lending support initiatives and approaching businesses about borrowing requirements) might lower the number of DBs from 173,000 to 50,000.

What proportion of these 123,000 additional prospective applicants are creditworthy? Whilst we do not have access to bank data/credit evaluation models to obtain a direct answer to this question, using the model/data in the report we are able to estimate the number of businesses which might receive a loan or overdraft if they applied. Using this approach we estimate that, if bank issues were fully addressed, about 77,000 (63% of the 123,000 additional prospective applicants in this scenario) might be suitable for bank finance.

Fully addressing business related issues (principally, improving debt/cash-flow management skills) instead might reduce the number of DBs to 110,000. Proportionately more (75%) of the 63,000 prospective additional applicants in this case (corresponding to around 47,000 businesses) might be suitable for bank finance due to the improvements in the quality of applications brought about by addressing debt/cash-flow management issues.

Since the data relates only to bank finance we do not know how (more) suitable any of the businesses examined might be for non-bank finance. This is an area worth investigating further in future research with data involving both bank and non-bank finances. Also, the findings speak mainly to the indirectly discouraged given that they form the bulk of the DBs in the analysis (although, as noted previously, the model is robust to separate analyses of the indirectly/directly discouraged). However, again it would be worth taking a further look in future research at potential differences between the indirectly/directly discouraged in terms of their creditworthiness (perhaps using bank data for the directly discouraged).

What might encourage DBs back to borrowing?

As confidence in the economy returns we would expect perceptions to improve and the number of DBs to fall (although the report highlights ongoing issues with business confidence which may slow this 'self-correction' in discouragement). In terms of taking active steps to encourage more businesses, which are potentially suitable for bank finance, 'back to borrowing' the report indicates that a sensible strategy involves addressing both bank and business issues.

The principal recommendations in the report centre on increasing effort and/or raising awareness in relation to existing policies/measures since the research indicates that these actions could significantly reduce the number of DBs.

To help improve perceptions by increasing businesses' satisfaction with their banking relationships:

R1. Banks should take steps to ensure the Lending Code/Principles are implemented more consistently and effectively.

Due to the beneficial effects of raising awareness of lending support initiatives on perceptions/application costs, given the current low rates of awareness of these initiatives and recognising business support groups can help communications as a 'trusted voice':

R2. Banks, the British Business Bank and business support groups should seek to raise awareness of the Lending Code/Principles.

R3. Banks, the British Business Bank and business support groups should seek to raise awareness of the Appeals Process.

To increase businesses' awareness of their credit health, provide support to help improve credit health and to help businesses that are unsuitable for bank finance to find more appropriate alternative sources of finance:

R4. The British Business Bank, assisted by banks, credit reference agencies, business support groups and alternative finance providers should consider forming a working group to explore how they can: i) enhance businesses awareness of their credit health and the steps they need to take to improve their credit health; and

ii) help businesses find alternative providers of finance where this is more appropriate.

To provide extra support for smaller/younger businesses which are less financially confident and find applying for loans more difficult:

R5. The British Business Bank and business support groups should seek to raise awareness/take-up of support from the Start-Up Loans Company.

To encourage more viable businesses which are put off from applying due to a lack of security:

R6. The British Business Bank and business support groups should seek to raise awareness/take-up of the Enterprise Finance Guarantee.