Avoiding the pig in a poke by the help of banks

A way towards transparency for non-bank investments in SME

Facilitating access to financial resources for small and medium sized entities (SME) is well-grounded on the European Unions’ agenda. It seems to be common sense that banks struggle to remain their role as SME’s faithful lender.\(^1\) Banks have at the same time been dominating the market. In 2012 bank loans’ share in SME financing was at about 73 % in the €-area.\(^2\) In economies with historically different financing cultures numbers are more diverse. Bank loans in the US account for only approx. 20 % in funding businesses.\(^3\)

Especially innovators are forced to look for alternatives to bank loans for their own sake and implicitly for the sake of the economy. Banks can hardly fund (often risky) innovations as their own lenders have a system-relevant unconditional claim on repayment. This matter is intensified by regulations based on the Basel III accord. The EU initiatives COSME and HORIZON 2020 here will do a lot of good\(^4\) but can’t do all by nature.

The EU consultation at stake on the creation of a single capital market union contains a further initiative by the European Commission to improve SME access to finance.\(^5\) The aim is to widen the investor base in SME easing their predominant dependency on banks to meet their funding needs.

The first plain vanilla alternative for SME to bank loans however, access to public organized and regulated capital markets, is by default severely restricted or denied.\(^6\) Reasons are amongst others the size of funding necessities combined with high cost for fees and disclosure requirements.

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\(^2\) Ref. Creditreform Rating AG/IKB Deutsche Industriebank AG: Wachstum finanzieren. Eine Analyse der sich wandelnden Finanzierungsmuster im deutschen Mittelstand, August 2014, p. 21


\(^4\) Ref. Meeh-Bunse/Schomaker: Neue EU-Förderprogramme Horizon 2020 und COSME als alternative Finanzierungsform, in: DStR 2013, P. 2291


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Hence private placements where institutional investors grant loans directly to SMEs as well as crowdfunding are two examples of more or less unregulated markets which could and do serve as an alternative to bank loans.

A prerequisite for a sustainable successful funding on these still unregulated markets seems to be transparency in credit-worthiness, not taken into account unconditional funding willingness by supporters of film stars, soccer clubs etc. However, this prerequisite is often not implemented. Most recently this lack is reinforced by the ease of reporting requirements for smaller entities. Asymmetries between borrowers and lenders are inherent.

Hence these asymmetries should be overcome. Hiring one the established and hence trusted rating agencies for SMEs is practically ruled out due to cost. The challenge is to find a “win-win-win situation” for the established SME-lenders (the banks), the potential new SME-lenders (e.g. laymen as part of the crowd or institutional investors willing to lend to smaller companies, too) and the SME itself.

A first step in overcoming asymmetries can be seen in the European Union’s recommendation to improve transparency between banks and SME as borrowers, e.g. by high quality feed backs from banks for the SME loan applicant.

Simultaneously and in consequence banks do hold information about the credit-worthiness of an SME as its (potential) borrower which is processed by their risk assessment systems. These systems commonly are quality assured. The information is at hand either by continuous business relationship or by the first loan application which could prospectively be altered or extended into a risk-assessment application: Even though banks may not lend to SMEs due to their above mentioned restrictions their fortitude on rating customers (e. g. SMEs/entrepreneurs) and on rating their

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projects can contribute positively by supplying existing (but unpublished) data for alternative forms of financing (e.g. crowdfunding). This data so far lays idle within the bank. So what about preparing already existing, crucial (but unpublished) data through a centrally organized institution? Rating data, which is already made up by banks or alternatively mandated by businessmen, could be accumulated, harmonized and provided to potential investors without generating additional costs for value.

On request of the SMEs – such information could be made available to third party potential investors. The bank could profit from a fee for this service. The third party investors could benefit from transparency and hence avoid lending to a pig in the poke. SMEs on the same hand could benefit from improved funding possibilities on so far non-regulated markets as they indirectly provide for transparency. In this way they can avoid being regarded as being the big in the poke.

In summary we recommend three measures to improve the availability of SME credit information\textsuperscript{13}:

- establishing general regulations that allow banks with agreement of the SMEs to externalize their so far internal information on the SME’s credit-worthiness
- establishing an institution that collects, edits and makes available such information
- to reconsider existing easements in transparency for SMEs in order to avoid negative boomerang effects by making “the pig in the poke” bigger.

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