Policy Briefing

An Empirical Examination of Discouraged Borrowers in the UK

Research Paper 69

May 2018

For the most part, prior academic research has closely investigated the characteristics of SMEs who apply for credit (but are denied) to fund future growth. SMEs that require finance, but who do not apply for fear of rejection - '*discouraged borrowers*' - have often been ignored. In this paper, using data from the first two waves of the Longitudinal Small Business Survey (LSBS), we investigate the underlying differences between SMEs that apply for funding and those that are discouraged from applying for funding. We also investigate the evolution of borrower discouragement and how this impacts on SMEs' activities.

Key findings

Data from the Longitudinal Small Business Survey suggests that one in ten SMEs (9.3%) can be classified as being a discouraged borrower or as many as half a million UK SMEs could be discouraged borrowers. Micro SMEs (employing between 1-9 employees) reported the largest levels of borrower discouragement compared to larger SMEs. Service sector SMEs are less likely to be discouraged borrowers compared to manufacturing counterparts. Discouragement also varies strongly in terms of a firm's future growth-orientation, with growth-oriented SMEs substantially more likely to be discouraged borrowers than non-growth-oriented counterparts.

Discouraged borrowers can be found across all the regions throughout the UK, however, London stands out as the region with the greatest overall level of discouraged borrowers (15.7% in 2015). More generally the regions exhibiting higher levels of borrower discouragement are more peripheral in nature.

At a more personal level, the biggest single factor shaping the overall intensity of borrower discouragement is risk aversion. The unwillingness of entrepreneurs to take on additional risk was one of the critical factors explaining their (self-imposed) borrower discouragement. Another was fear of rejection and concerns with prevailing economic conditions.

What drives discouragement?

One of the advantages of the LSBS is that apart from reporting SMEs' main reason for borrower discouragement, it also asks SMEs to disclose all of the reasons that could drive their discouragement (Figure 1). Our results suggest that firm size, growth orientation, financial losses, female and minority ethnic group ownership, sole proprietorship and company legal status are associated with higher levels of borrower discouragement intensity. Lower capabilities in people management and accessing external finance are associated with higher borrower discouragement intensity.

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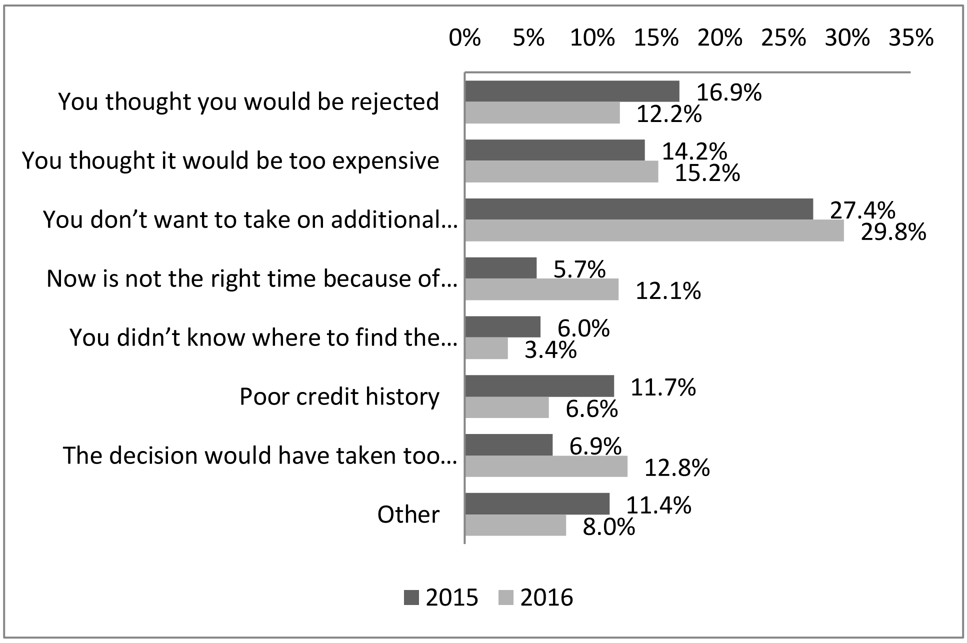
Figure 1: Main reasons for borrower discouragement: LSBS 2015 and 2016



In terms of the personal factors shaping discouragement, a number of features are notable. First, the second greatest concern fostering discouragement was the view that the finance would be too expensive. Second, another factor shaping borrower discouragement is the personal credit history of the entrepreneurs in question. Third, and perhaps more surprisingly was the fact that such a sizeable proportion of entrepreneurs cited the lack of speed as a source of discouragement. This may explain why some SMEs seek more rapid sources of finance such as crowdfunding and peer-to-peer lending as a way of avoiding traditional sources of bank finance.

Policy and practice implications

The results of this study suggest that there are useful lessons for UK policy. First, interventions may be formulated better if they are more strategically targeted towards SMEs most at risk of inappropriate discouragement. For example, growth-oriented SMEs in sectors such as manufacturing and ICT may warrant specially targeted policy measures. Micro firms rather than medium-sized enterprises also seem more prone to discouragement and may need specific targeting. Focusing efforts towards particular types of entrepreneurs such as women and ethnic minorities might also be another useful form of policy targeting.

In terms of policy instruments, one innovative step to address informational asymmetries would be to develop a bespoke online informational service – akin to a public version of a price comparison website such as Money Supermarket.Com. This could potentially enable SMEs to gauge their true chances of obtaining finance and at what cost offered by different financial providers. Imaginative policy steps such as this could mitigate inappropriate discouragement whilst simultaneously helping to raise the levels of competition within the UKs' oligopolistic SME lending market.

Full paper link:
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