State of the Art Review

# Regional Differences Accessing Finance in UK SMEs: Do they matter?

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**In recent years, there has been a growing body of empirical evidence examining spatial variations in access to bank finance in UK SMEs. The overwhelming bulk of this work suggests a firm's geographic location plays a crucial role its ability to access finance. Innovative and growth-oriented firms seem those most affected. Regions most adversely affected are peripheral and rural areas with sparse bank branch networks. The main causes of these disparities seem to be connected to the pervasive use of new automated lending technologies and the rapid decrease in the size of the UK bank branch network. The knock-on effect of these trends may be increasing the use of other forms of substitutive finance and increased levels of borrower discouragement within SMEs located in peripheral areas. From the evidence base reviewed, it would appear that regional funding gaps do exist and they do matter. The full impact of their effects on firm performance and wider economic growth remain unknown however.**

## Background

The issue of whether a firm's location influences its ability to access finance in SMEs is a growing area of academic interest. This topic is also of keen policy interest, especially given the number of bank branch closures in recent years coupled with repeated calls for regional investment banks. Historically, much of the evidence surrounding geographical variations in access to finance focused on equity finance such as venture capital (VC). This work strongly reveals VC and business angel funding to be heavily concentrated in certain parts of the country, especially London and the south-east of England (Mason and Pierrakis, 2013). However, much less evidence has considered whether debt finance, such as bank loans, vary geographically in the UK.

Traditionally, small business debt-based finance was considered to be a localised affair underpinned by relationship-based lending which enabled the transferral of soft information between the small business and the lender. This form of banking alleviates the informational opaqueness and lack of collateral in SMEs (Berger and Udell, 1998). However, during the last two decades or so, banking has undergone a series of fundamental changes, particularly the introduction of “lending technologies” used by banks to automatically evaluate lending decisions such as credit scoring and balance sheet checks which have increased the “operational distance” between SMEs and banks.

Another crucial change affecting access to finance in SMEs has been the rising “functional distance” (i.e. the distance between the banks HQ and local branch) between bank borrowers and lenders. This has been strongly fuelled by the restructuring process undertaken by banks following the global financial crisis (GFC) and significant decline in the bank branch network across the UK which has heavily affected poorer and more remote regions the hardest (Leyshon et al, 2008; Lee and Calabrese 2018). In theory, less relationship-based and localised banking could hinder access to finance in SMEs.

## Evidence

So what does the evidence tell us? Since the GFC, studies examining access to finance in SMEs show that since this period access to credit has become more problematic for many UK SMEs (Cowling et al, 2012). Importantly, there has also been an upsurge of studies examining the role of geography in the access to finance in the UK. The bulk of this evidence suggests SMEs located in peripheral and rural regions find it harder to access all forms of SME finance (see Table 1 below). This has been confirmed by different studies using different data sources covering differing time periods (see Mason and Pierrakis, 2013; Degryse et al, 2015; Lee and Brown, 2017; Zhao and Jones-Evans, 2017). While these findings largely correspond with other studies from other EU countries (Donati and Sarno, 2014), some UK studies find no greater problems for SMEs in deprived areas (Lee and Drever, 2014).

**Table 1: Geography and Access to Finance in SMEs**

| ***Study*** | ***Data*** | ***Empirical Context*** | ***Key Findings*** |
|---|---|---|---|
| Mason and Pierrakis (2013) | British Venture Capital Association | UK | Early stage VC is heavily concentrated in London and the south-east of England |
| Donati and Sarno (2014) | Panel data of SMEs | Italy | Reliance on internal growth finance more important for SMEs in backward regions than core regions |
| Lee and Drever (2014) | Small Business Survey | UK | SMEs in deprived areas find it no harder to access finance than those located elsewhere |
| Degryse et al (2015) | FAME/BankScope/Annual Clearings Directory | UK | SMEs with a lower functional distance had less credit constraints during the financial crisis |
| Zhao and Jones-Evans (2016) | SME Finance Monitor | UK | Greater functional distance between bank headquarters and branches exacerbates the credit constraints faced by local SMEs |
| Lee and Brown (2017) | SME Finance Monitor | UK | Strong evidence that innovative SMEs in peripheral regions have their applications for finance rejected |
| Brown et al (2018a) | SME Finance Monitor | UK | SMEs located in peripheral regions have greater usage levels of credit card finance and innovative and |

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| | | | growth-oriented SMEs are the most predisposed to this form of finance. |
| Brown et al (2018b) | Longitudinal Small Business Survey | UK | Discouraged borrowers are more prevalent in London and peripheral UK regions |
| Lee and Calabrese (2018) | SME Finance Monitor/Points of Interest | UK | Firms in areas with more bank branches are more likely to successfully obtain finance whilst bank diversity does not matter |

Interestingly, a study by Lee and Brown (2017) found that certain types of peripherally-located SMEs are particularly affected by these credit constraints. Innovative SMEs in particular are more likely to have their bank loan applications rejected than those located in core regions. They were also more likely to be discouraged from applying altogether for fear of rejection.

In the last few years, a number of studies have examined some of the potential causes and effects of these difficulties accessing finance in some peripheral/rural regions. In terms of causes, an important recent study has found that credit restrictions are greatest for SMEs in regions with the least number of bank branches (Lee and Calabrese, 2018). By contrast, the diversity of different banks had little bearing on access to finance in SMEs. This suggests that the huge decrease in bank branches may have exacerbated credit constraints for SMEs in more remote UK regions.

The possible effects of these credit constraints in SMEs have also been examined recently. In one study it was found that SMEs located in peripheral regions have a greater use of costlier forms of finance such as credit card finance (Brown et al, 2018a). Therefore, SMEs found to face the toughest credit constraints –such as innovative and growth-oriented firms – had the strongest propensity to seek recourse to credit card finance. Another recent study discovered that levels of borrower discouragement are also higher in peripheral UK regions (Brown et al, 2018b). This suggests that problems accessing credit may lead to the use of substitutive forms of funding and increased levels of discouragement.

## Evidence gaps

There is now a growing (albeit incomplete) body of evidence examining spatial variations in access to finance in UK SMEs. A SME's geographic location seems to play a crucial role in shaping the ability of a firm to access finance, a problem accentuated for innovative firms. In sum, debt finance markets for SMEs appear just as spatially constructed as equity markets.

However, whilst the evidence has increased greatly, our knowledge remains partial. For example, there is less evidence on the impact of these regional funding gaps. We can speculate however that it will significantly reduce investment and growth within affected SMEs. More work on the potential negative spillovers of credit constraints in peripherally-located SMEs is therefore needed to help public policy better target initiatives to mitigate these negative impacts.

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