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Does Bank Market Power Affect SME Financing Constraints?

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This paper investigates the impact of bank market power on investment financing constraints experienced by small- and medium-sized enterprises (SMEs). It uses a large sample of approximately 118,000 SMEs across 20 European countries over the period 2005-2008. Our main contribution is to test the degree to which firms are financially constrained and investigate how such financial constraints vary by the degree of market competition between domestic banks.

We find that firms' investment is sensitive to the availability of internal funds and interpret this as being indicative of European firms facing financing constraints. When testing the effect of bank market competition on access to finance, we find that as market power increases, and the degree of competition falls, SMEs face higher financing constraints.

Our research provides a number of important insights for SME credit policy in the context of Europe's economic recovery and in terms of financial stability. The very heterogeneous impact of the financial crisis on domestic banking sectors in Europe has led, in many cases, to a retrenchment towards domestic activity. This is a result of the extensive, but necessary, state intervention to provide banking sector support and restructuring. If such restructuring significantly lessens competition between financial institutions, our findings suggest that this will lead to an increase in financing constraints for SMEs. Such credit constraints, if binding in the medium term, will inevitably lead to lower investment and potential output. Policy actions which ensure financial stability but provide for additional (or even just restore) competition in the European lending market for SMEs will be a necessary condition for future SME growth and be supportive of economic development.

The research is also particularly important in the context of Ireland's financial recovery. The structure of the banking system has changed dramatically following crisis, with considerable market exit by foreign banks and required consolidation

[1] Ryan, R., O'Toole, C. M., & McCann, F. (2014). Does Bank Market Power Affect SME Financing Constraints? Journal of Banking & Finance, published online: http://dx.doi.org/10.1016/j.jbankfin.2013.12.024

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between domestic financial institutions. This has substantially lessened competition for business credit in Ireland with only three main retail business banks remaining. This reduction in competition poses serious questions regarding the ability of the financial system to transmit credit to SME borrowers in a recovery scenario. If competition between financial institutions in Ireland is lacking, the risk of increased SME credit constraints heightens. Policy measures to restore competition in Irish banking are required to ensure the system can provide the credit required to fund economic recovery.

Finally, as we find that the effect of bank market power on financing constraints is stronger in financial systems that are more bank dependent, this would imply that further developing alternative liquid financing sources for SMEs in Ireland, and Europe, would help develop a more stable financing environment. This would provide firms with a number of financing choices and the possibility of following a more diversified financial structure. The recent commitment in the government's Medium Term Economic Strategy to broaden the financing landscape for Irish SMEs is welcome in this regard.