EFFECTS OF FINANCIAL SECTOR FOREIGN DIRECT INVESTMENT ON ACCESS TO CREDIT FOR SMALL AND MEDIUM-SIZED ENTERPRISES IN EMERGING MARKET ECONOMIES: A CRITICAL COMMENTARY

Manuela W. Armenta
Norman Paterson School of International Affairs, Carleton University

This article provides a critical commentary on the literature surrounding the effect of FSFDI on the SME market for access to financing. It begins with a critique of a study by Clarke et al. (2002), on the basis of both methodological and substantive issues. The author goes on to argue that barriers to credit for SMEs often derive from the banking sector's requirement for quantifiable, standardized forms of information that many smaller, semi-formal firms do not have available to provide. For this reason it may be crucial to examine the basis upon which credit is granted rather than simply the quantity of credit lent or its price. More specifically, it is important to determine whether credit is granted using transaction-based or relationship-based methods. The author goes on to suggest that competition, rather than foreign investment *per se*, may be a crucial variable in enhancing the likelihood that domestic banks will service informationally-opaque SME niches. Moreover, the author points out that domestic banks may be poorly managed and subject to capture by special interests, which calls into question how desirable they are as alternative lenders, notwithstanding their willingness to engage in relationship-based, rather than transaction-based lending. Improvements to internal credit and management practices are therefore necessary to increase the ability of these institutions to service all clients, including SMEs, effectively. Technical assistance and capacity building that assist SMEs in overcoming the problem of information opacity may also reduce the likelihood of SMEs being phased-out of existing relationships and greatly enhance access in the long-run.

INTRODUCTION

The 1990's witnessed the lifting of investment restrictions on financial sector foreign direct investment (FSFDI) in many Latin American emerging market economies (EMEs) leading to unprecedented levels of foreign ownership in the sector. As a result, both the structure and stability of affected domestic banking industries changed. Numerous studies focus on the aggregate effects that FSFDI has had on banking sector efficiency and stability; it remains less clear whether the effect of FSFDI has been beneficial or harmful for small- and medium-sized enterprise (SME) access to credit. This article re-examines what is already known about financial systems and the credit constraints faced by SMEs. It then provides comments on existing empirical studies surrounding the positive and negative effects of FSFDI on the ability of SMEs to access credit. The article critiques Clarke et al. (2002) by arguing that their results may not be generalized. Clarke et al. (2002) argue that SMEs are, on balance, better off due to FSFDI because increasing efficiency within the industry assists all firms, including SMEs. Moreover, they argue that domestic banks may develop SME niches to capitalize on the SME lending opportunities foreign banks eschew. By contrast, this article suggests that the negative short-run effects of FSFDI may overwhelm or diminish the positive medium- to long-term benefits discussed in the literature. Three possible short-run effects are explored: (1) barriers to credit faced by SMEs increase, *ceteris paribus*, because foreign-owned banks focus on transaction-based lending; (2) domestic banks only develop niches that cater to SMEs under certain conditions and may be sub-optimal alternative lenders; and (3) standing lending relationships are harmed or severed and associated costs may be high. This article is not arguing that existing empirical studies are incorrect; rather, it critically examines the assumptions and the data used in some studies to determine how representative their conclusions are for the majority of SMEs in the Latin American region. This article provides a critical commentary on the existing literature in an effort to demonstrate how the absence of certain conditions may lead FSFDI to have net negative rather than net positive effects on SME access to credit.

Methodologically, this article begins with a literature review, examining established theory and evidence on the effects of FSFDI on SMEs' access to credit in Latin American markets. Using Mexico as a mini case study, the article demonstrates how an increase in FSFDI may, under certain conditions, result in a reduction in SMEs' access to credit. The article concludes with a call for further research into the conditions under which the 'net' effect of FSFDI is likely to be positive on SMEs' access to credit in Latin America, and some reflections on the implications of such research for policymakers.

DEFINITIONS, BACKGROUND, AND MOTIVATION

FSFDI Background

According to a report by a working group at the Bank for International Settlement's Committee on the Global Financial System, FSFDI is defined as "international investment that reflects the objective of a resident entity in one economy obtaining a lasting interest in a firm resident in another economy. Hence, it [FSFDI] refers to control rather than a specific form of financing" (Bank for International Settlements 2004, 7). In the Latin American context, FSFDI grew rapidly during the 1990s following the liberalization of highly inefficient financial systems in countries including Mexico, Argentina, Chile and Brazil. The financial markets in these states had long been distorted by interest rate ceilings and directed lending (Todaro 2003, 746). In the wake of economic liberalization and debt crises, banks were often illiquid or insolvent and holding sizable bad debt. With severely undercapitalized banks, governments hoped foreign investment would bring much needed liquidity. FSFDI, via mergers and acquisitions of troubled domestic banks, followed. At the industry level, the theoretical benefits included recapitalization, stability, efficient institutions and spillover to domestic banks (Cardenas et al. 2003, 1-2). It is, however, not guaranteed that all such industry-specific effects occur. It is also not clear that they directly or indirectly support greater access to credit for SMEs. On the contrary, it is possible that in some cases FSFDI simply exacerbates the barriers to access to credit already faced by SMEs; this question is examined in further detail later in the article.

What are SMEs and why do they matter?

Admittedly, the term SME is somewhat vague; the academic literature contains a number of different definitions of what constitutes a small- or medium-sized enterprise. Various governments define the term differently as well, further complicating matters. In general however, an SME can be described as a business with a limited workforce and payroll, and with limited access to international markets. They are distinguished from micro-enterprises both in size and in degree of formality, though here again boundaries are fluid between categories. In a study conducted for the International Development Research Centre, Lerchs (2002) identified a range of different government definitions. Egypt considered SMEs to include firms employing between 5 and 49 people, while the European Union (EU) included firms employing up to 250 employees. To highlight the degree of confusion, the Mexican government actually employs two different formal definitions of the term, including all firms with up to 250 or 500 employees.

Understanding the characteristics of SMEs and what they offer to an economy explains why barriers to their growth and expansion should be minimized. Lerchs (2002) suggests that small firms in the developing world are often run by individuals living just above the poverty line. The same study suggests that average income levels tend to increase with the size of the firm (Lerchs 2002). These firms are also generally lower-productivity firms, meaning that they may provide relatively lower-skilled employment opportunities, thus potentially promoting inclusive growth and equity (Saavedra 2003). Mexican census data suggest that these firms account for 26 percent of employment. Theoretically, if one could increase productivity among such firms they could become more profitable, thereby creating new employment opportunities, increasing average incomes, and generating economic growth. In smaller firms it is plausible that these benefits would accrue to employees, who on average may be relatively poorer than employees of larger firms. Although tentative, these theoretical linkages suggest a strong case for supporting SMEs as part of a broader pro-poor development strategy.

SMEs and Access to Credit

Small firms have the potential to increase productivity via innovation and expansion. Firm theory, developed by Schumpeter (1968), argues that credit leads to increased firm productivity by enabling the acquisition of technology, implements and additional labour.[1] In addition, Claessens (2006) recently noted that credit makes it easier for firms to capitalize on new growth opportunities. Although factors in the business environment—ease of firm entry and exit, property rights and contract enforcement to name just a few—are important to the survival and development of SMEs, finance accelerates growth by providing the means for firm start-up, expansion, and efficient resource allocation (Klapper, Laeven, Rajan, 2004 as cited in Claessens 2006, 210). Empirical evidence also tells us that barriers to credit negatively affect the growth of SMEs more than the growth of large firms (Beck et al. 2003). Further testing is required to confirm the theoretical linkages presented above; however, assuming they hold, and taken together with the “pro-poor” linkages discussed earlier, there is a strong case for developing policy initiatives aimed at reducing barriers to credit for SMEs.

Barriers to Credit

Aside from the possible effects of increased FSFDI – whether positive or negative – SMEs in general face considerable barriers to gaining access to credit. A crucial barrier relevant to the discussion of FSFDI and SME credit is information opacity. SMEs are what Berger (2001) refers to as “informationally opaque”. Not only are SMEs, by nature, relatively more risky to finance than large firms, information opacity, or a lack of concrete, accessible and objective information makes it difficult for banks to accurately assess the risk involved with a particular project. Holding constant the level of financial development between states, SMEs tend to have less quantifiable information and the information they do have is often less verifiable in the objective, standardized forms familiar to financial institutions (i.e. credit bureau scores and reliable financial statements). Consequently, the bank has less information about the project than the firm; in economic terms this is known as information asymmetry. This can affect the ability of small firms to obtain financing if, due to information asymmetry, banks compensate for risk by increasing the cost of borrowing (especially if it is to the point where SMEs cannot afford a loan). In some cases, banks may even rule SME lending out completely due to risk and the potential associated costs (Claessens 2006, 222).

EFFECTS OF FSFDI ON SMES’ ACCESS TO CREDIT IN LATIN AMERICA; A REVIEW OF THEORY AND EMPIRICAL EVIDENCE

FSFDI and SMEs – Net Effects

Numerous studies examine the effects of FSFDI on domestic economies and some look specifically at its effect on SMEs. This article argues that the question of net benefit versus net harm depends on a number of context-specific factors and must be analyzed on a case by case basis. For example, the net effect may change depending on whether the analysis focuses on short-term results–particularly during the immediate aftermath of a significant increase in FSFDI–or long-term effects that emerge years, or perhaps even decades after the influx of foreign investment. Further, findings regarding the net effect may in fact change from study to study, depending on how widely one defines the effects. Indeed, one serious shortcoming within the current literature is that most studies rely mainly on econometric analyses; consequently, some effects doubtlessly remain unobserved and unexplained due to data constraints and analytical insensitivity to less quantifiable externalities. Analyzing outliers, both those that perform better as well as those that perform worse than predicted by the model is necessary, especially over time, to determine the context-specific factors that enhance rather than diminish access to credit for SMEs.

Clarke et al. (2002) argue that SMEs are, on balance, better off due to FSFDI because increasing efficiency within the industry assists all firms, including SMEs. Moreover, they argue that domestic banks may develop SME niches to capitalize on the SME lending opportunities foreign banks eschew. Their study looks at the impact of foreign bank presence on firms' access to credit, disaggregating firms according to size to determine if size differences predict different outcomes for access. Using survey data from 3,000 enterprises in 36 developing and emerging economies, the authors use cross-section regression analysis to test whether access to credit is associated with foreign bank presence. To conduct the analysis, they use two dependent variables: borrowers' perceptions of interest rates and access to long-term credit as constraints to growth, controlling for macroeconomic, institutional, and firm-specific factors. They hypothesize that if the potential advantages of foreign bank entry in developing countries outweigh the tendency of foreign-owned banks to abstain from SME lending, then all borrowers, including SMEs, should rate both variables measured as lesser constraints to growth in states with relatively more foreign ownership. The analysis is meant to capture the "net effect" (direct plus indirect) of FSFDI. The regression results indicate that all firms, including SMEs, rank interest rates and long-term credit more favourably in states with higher foreign ownership. These results suggest that, at minimum, SMEs are not harmed by foreign ownership, and may benefit in some cases. Clarke et al. provide two potential causal explanations for the positive finding. First, they cite cross-section evidence that overall sector efficiency (increased competition, stability, efficiency, technological and skill spillover) leads to lower interest margins and overhead costs. Moreover, if these efficiency gains lead to an overall expansion in total lending, then even if foreign banks lend a lower percentage of funds to SMEs, the actual dollar value of funds lent could still be rising. Second, if foreign banks compete with local domestic banks for larger clients, then in response local banks may shift into targeting the SME market.

Both of these theoretical explanations are valid and even plausible, however, neither of them rules out the possibility that many SMEs are harmed by foreign investment. Effectively, the theory and the concurrent results at best suggest that in some cases harm may be offset by benefits for sampled firms. Therefore, the firms may experience harm and benefit concurrently and one more than the other in short-run versus the long-run. This article is not suggesting that Clarke et al. are incorrect in arguing that expansion of overall domestic lending has led to a larger aggregate quantity of funds to lend and reduced interest rates for firms with loans.

Any insight, however, that can be gleaned from the Clarke et al. study can only be applied to the kinds of firms surveyed in the study; recalling that the study only surveyed firms that already had access to credit makes it difficult for the study to shed light on the effect of FSFDI on all SMEs. By including only borrowers, the findings are limited to firms that had successfully obtained and/or maintained credit following the structural changes brought about by FSFDI. Arguably, such a selection bias excludes the firms that are most likely to complain that they are not, from a net perspective, better off, i.e. firms that were either unable to get credit, or that lost access in the FSFDI-infused market. At minimum, such findings, limit how far the results may be generalized and suggest that the authors have not gone far enough in their testing.

Moreover, it is possible that SMEs do not rely upon long-term loans in the same way that larger firms do; thus the results on this variable may also overstate the benefits to SMEs if this type of credit is less relevant to their growth.

This next section explores why it is plausible that many firms without prior access to credit likely suffered net harm, especially in the short-term. The critical issue is that the information opacity problem remains regardless of whether the overall quality and quantity of lending allocated to SMEs expands. As was discussed earlier, foreign-owned banks rely relatively heavily upon quantifiable data to assess and grant credit and SMEs can not often provide such data (Cardenas et al. 2003, 2). Foreign firms have standards and credit analysis techniques that cannot be circumvented. Therefore, only SMEs that can meet these requirements will have access to credit. This article therefore argues that foreign firm investment raises the already substantial barriers to credit, *ceteris paribus*, for those firms that are *ex ante* outside the borrowing pool.

THREE ISSUES REQUIRING FURTHER CONSIDERATION: INFORMATION, SME NICHES AND ADJUSTMENT COSTS

Information

As noted, SMEs are informationally opaque, a fact limiting their ability to access formal credit instruments. Berger et al. (2001) suggest that one way to circumvent information opacity is via 'relationship lending' wherein the information gathered includes both quantifiable and less quantifiable data. Rather than relying on financial statement information alone, the lender gathers qualitative information about the firm from interviews with the owner and contact with other businesses including suppliers, customers and the local community with whom the firm has a long-standing reputation-based relationship (Berger et al. 2001, 2129). Over time this relationship grows and becomes more valuable as more data is accumulated.

Relationship lending is particularly beneficial because the information collected is used to make decisions on loan renewals, credit increases and renegotiations that tend to become increasingly favourable to the borrower in the medium- to long-term (Berger et al. 2001, 2130). As the relationship strengthens, information asymmetry falls and as a result, so does the risk borne by the lender. Consequently, the price of borrowing, often reflected in the interest rate, falls (Berger and Udell 1995). Berger et al. (2001) also cite a number of empirical studies which found that collateral requirements also tend to fall over time and that the quantity of credit provided tends to rise.

Transaction-based lending, conversely, relies relatively heavily upon readily available, quantifiable data that can be easily verified by financial statements and transparent agencies. Due to their size and level of sophistication, foreign banks may rely upon transaction-based lending techniques rather than relationship-based approaches. Theoretically, the use of transaction-based lending is one of the reasons why asset quality improves in banks acquired by foreign owners. Foreign owners transfer credit analysis and risk management systems as well as skilled managers from their home markets which are more often than not, developed country economies (Schulz 2006, 12). These systems and staff are sophisticated relative to their counterparts in newly liberalized financial sectors and evaluate credit using computers and credit scoring techniques that expand loan volumes while minimizing risk (Schulz 2006, 26).

Conversely, transaction-based lending is not conducive to absorbing local information and assigning it value, whereas, relationship-based lending is; this is why lenders willing to lend on the basis of relationship-based approaches can be critical to SMEs' prospects for accessing credit.

To further compound the factors discussed above, foreign banks are often headquartered in markets that are very different from host EME markets. Language, cultural, supervisory and regulatory differences combine to increase information asymmetry and the ease of monitoring loans and therefore the costs of lending to firms that rely on relationship-based lending techniques, namely SMEs (Berger et al. 2001, 2131-2). In short, there are a number of structural and cultural obstacles which limit the willingness and the ability of foreign banks to lend to SMEs. FSFDI thus arguably increases the barriers already faced by informationally opaque firms seeking loans.

Berger et al. (2001) confirm this argument. Using firm and bank data from the Central Bank of Argentina, they test whether large banks, foreign-owned banks, and distressed banks face barriers in providing 'relationship lending' (Berger et al. 2001). The study uses loan size, specifically the natural log of the sum of the firm's total loans from all banks, to measure information opacity. For the dependent variables, they used dummies to indicate when a bank was large, foreign or distressed. The findings show that both the large and foreign-bank hypotheses were true; small firms were the least likely to obtain loans from either type of institution. The situation was compounded if the institution was both large and foreign (Berger, et al. 2001).

Due to constraints on firm-level data, we cannot quantify how many SMEs would be affected by these constraints; however, it is clear that affected firms would be harmed through a narrowed range of options. In short, for informationally opaque firms it is moot to question whether the efficiency gains brought by FSFDI expand the aggregate amount of credit lent by foreign-owned banks unless it concurrently lowers the barriers to access to credit. It does not matter to informationally opaque SMEs how much bigger the credit pie gets if they still cannot get a slice. Based on the analysis here, it is fair to suggest that FSFDI increases rather than decreases barriers. The only potentially positive effect for such firms is thus an indirect one; as Clarke et al. (2002) suggest, SMEs may benefit if domestically-owned banks develop niches in SME lending, in order to compensate for business lost to foreign competitors.

The Likelihood of Domestic Banks Developing Niche SME Lending Lines

This section critically examines the likelihood that domestic banks will develop SME niches which could potentially increase the chances of SMEs gaining access to credit as an indirect result of FSFDI. In addition to Clarke et al. (2002), Berger et al. (2001) also suggest that the consolidation of the banking industry via mergers and acquisitions by large and/or foreign banks,

> …may not substantially reduce the overall supply of credit to informationally opaque small business because there may be “external effects” …That is, although relationship-based small business loans may be dropped by some large banks after M&As, other banks or non-bank lenders may pick up some of these loans if they are positive net present value investments (citation from Berger et al. 2001, 2133).

Mini-Case Study: Mexico

Though potentially beneficial to SMEs, positive “external effects” or indirect effects described may or may not actually occur. On the contrary, the emergence of SME niche lending in domestic banks depends upon a number of conditions, including the existence of a vibrant and viable domestic financial sector in search of new demand for credit. The example of Mexico demonstrates that this condition is not always met post-liberalization in EMEs. Similar to other Latin American EMEs, the post-debt crisis Mexican financial sector was severely undercapitalized. The government allowed foreign banks access to the financial sector at this time to help it recapitalize and to clean up the non-performing portfolios of illiquid banks. Although GDP started to grow again, credit to the private sector as a percentage of GDP did not (Barajas and Steiner 2002). During this “credit crunch” period many non-bank institutions and alternative financing schemes took up the excess demand (Economist, 2002). In a study looking at whether FSFDI improved the productivity of the Mexican banking system, Heiner Schulz (2006) finds that performance on the cost-side improved substantially; provisions for non-performing loans fell (Schulz 2006). Competition in the industry, however, did not improve. The result was higher interest rate margins and larger fee income to banks. In other words, foreign banks imported sophisticated credit scoring models and risk management processes to expand loan volumes while lowering their credit risk. Cutting costs by reducing risk made their business sufficiently profitable such that the foreign banks did not have to compete by lowering the prices of their lending products and services. By 2002, foreign banks controlled 85 percent of the banking industry in Mexico. The market power of foreign banks allowed them to effectively monopolize which firms obtained access to credit—more lucrative, larger borrowers that could afford to pay the fees and represented relatively low risk. As the Economist observed at the time,

> Small and medium-sized businesses, to which the government of President Vicente Fox has given high priority, remain desperately short of funding. Even if entrepreneurs can get a small loan, they pay interest roughly 20 percentage points higher than the 8 percent underlying rate (Oct.12, 2002).

With only one domestic bank remaining and increased barriers to credit in place due to foreign banks' utilization of imported credit and risk techniques, SMEs faced extremely limited alternatives in Mexico.

FSFDI in this case did not foster increased competition and the entry of new domestic banks to serve SMEs. Consequently, SMEs faced increased barriers to credit due to a preference by foreign owners both to conduct transaction-based lending and maintain high interest rates and fees. On balance, the evidence suggests that SMEs in Mexico faced higher barriers to credit as a result of FSFDI. The Mexican example suggests that FSFDI is likely to produce pro-SME, and by extension, pro-poor, outcomes only given the existence of certain conditions; one important condition being competition. Clearly, further research is required to confirm the above insights from the Mexican example, and to identify other factors with the potential to limit the harm to SME access to credit and increase the positive indirect effects of FSFDI.

This author acknowledges that Mexico is only one example among many. A number of other studies suggest that other countries have had a more positive experience. Using cross-sectional survey data collected from banks in 60 countries, Jenkins (2000) examines the rate at which commercial banks lend to small firms and their reasons for servicing this market. The study only looks at micro and small business loans; therefore, for the purpose of this paper only the data on small business loans coming from private commercial banks are discussed. In the survey a small business loan is defined by loan size and ranges from USD $11,000-100,000. The data shows that out of the 148 banks surveyed, 88 make small business loans.[2] When asked about the top two reasons for making loans to this sector, 49 percent of the banks indicated profitability and 44 percent indicated "the changing market conditions and increasing competition in lending to large/medium enterprises" (Jenkins 2000, 5). The paper references how increased FSFDI contributed to increasing competition in developing state banking sectors and how many domestic banks lost large clients to foreign banks and accordingly began to look for new creditworthy customers (Jenkins 2000, 5). Of the banks that did not make small business loans, 40 percent cited "higher administrative costs of making these loans," and only 17 percent cited risk (Jenkins, 2000, 6). Finally, the study found that newer banks tended to lend a larger portion of their portfolios to small firms than banks that have been in business longer (Jenkins 2000, 8). This finding may support the contention that new banks are established to meet an emerging niche market in smaller firm lending. Jenkins cites the establishment of *Banco de la Pequene Empressa* in the Dominican Republic as an example of an institution specifically established to serve small firms (2000, 9).

Even though the Jenkins (2000) study was not confined to developing states in Latin America and did not specifically state that SMEs were being catered to because of the inflow of FSFDI, the loose connection was however made. The fact that domestic banks cater to SMEs because of "changing market conditions" does provide plausible evidence that the theory may hold in some countries. However, given Jenkins' reliance on a single cross-sectional survey of 60 countries, including developed, developing, and transitional economies, considerably more research is necessary to confirm the findings. In particular, research using panel data is necessary both to confirm that the findings hold within countries across time, and to identify any other potential outliers from the theory. This task will bring researchers closer to understanding that conditions such as healthy competition are established to make FSFDI relatively more positive for SMEs and to avoid cases like Mexico. In-depth case studies involving the collection of firm-level data are also necessary to determine the causal linkages in the case of Mexico.

The Desirability of the Domestic Bank Offsetting Effect

If in some cases domestic banks are an alternative, it is important to examine their quality as lenders. Over the short-run, for example, it appears that domestic lenders are sub-optimal alternatives. Borrowers obtain value from strong banking relationships with lenders that know how to select profitable investments and know how to monitor projects to ensure that they remain profitable. Borrowing funds involves an on-going contract with a lender and entails obligations and commitments on both sides. Borrowers often have to meet minimum financial reporting requirements and report on their on-going position regarding cash flow, liquidity, profitability and solvency. Skilled lenders provide expertise and therefore value to their clients through this iterated relationship. If domestic banks are inefficient, poorly operated, lack human capital and are vulnerable to special interests capture, they may be unwilling or unable to effectively and objectively evaluate which borrowers are most creditworthy and develop the types of relationships discussed.

There is strong evidence to suggest that in developing countries domestic banks are relatively inefficient at allocating credit; indeed, this is one of the core arguments underpinning efforts to increase FSFDI. A number of studies employing cross-country regression analysis find foreign banks in developing countries to be more efficient than domestic banks (Schulz 2006 cites Claessens et al. 2001 and Claessens and Lee 2002). In a paper for the World Bank, International Monetary Fund and Brookings Institution, Pomerleano and Vojta (2001) argue in favour of developing states welcoming foreign bank investment; however, in doing so, they also acknowledge that:

> This trend toward a two-tiered segmentation of banking services in emerging markets may result in competitive disadvantages for small and medium-size enterprises, whose growth prospects may be constrained by the service capacity of domestic banks. This issue certainly requires domestic banks to improve the capacity to serve SMEs (Pomerleano and Vojta 2001).

In other words, assuming domestic lenders are available as alternatives; SMEs may be forced early on to rely on relatively inefficient bankers. Although it may be argued that the domestic bank alternative is better than no alternative, it is critical to articulate the notable disadvantages for SMEs. Policy to improve the sound management of these institutions can be added to the previously noted need to ensure competition in the industry.

As discussed, prior to the 1990's domestic banks in emerging markets often operated under less than free market conditions. Pomerleano and Vojta (2001) outline areas where domestic banks could focus improvements including; the establishment of new policies and procedures for loan portfolio management, asset/liability management, information collection and monitoring systems as well as the recruitment and retention of appropriately trained staff.

The evidence that FSFDI results in spillover in these areas is scant and mixed; however, it suggests that spillover takes place within acquired banks rather than between foreign and domestic institutions (Schulz 2006). Though Pomerleano and Vojta (2001) note that there has been some transference in the area of management information systems, their examples cite mainly Asian cases rather than Latin American ones. Although this is not to say that such transfers do not take place in the latter region as well, important differences exist between the two regions that may limit how far such findings can be generalized. For example, foreign investors tend to control a much larger proportion of the banking sector in Latin America, thus limiting the number and capitalization of domestic banks ostensibly competing with one another for SME business. The potential for spillover effects will be a function of time and also the level of competition in the market. As a result, domestic banks may only be in a position to effectively meet the credit needs of SMEs once critical domestic banking sector reform, including institutional, regulatory and human capital development occurs. Spillover may occur in the long-run; however, this time horizon suggests that SMEs may continue to suffer from high barriers to credit which leave them capital deprived, or forced to engage in borrowing relationships with sub-optimal lenders until then.

FSFDI and Portfolio Clean-up

It has been established that FSFDI may in some cases increase the barriers faced by SMEs attempting to secure access to credit and force them to seek lending relationships with potentially sub-optimal domestic banks. This article has not, however, examined the effect of FSFDI on SMEs that may have already been customers of newly acquired or merged foreign-owned banks. The fact that foreign investment took place in

Latin American EMEs post-crisis, when banks were carrying significant levels of non-performing debt on their books, leads one to expect that significant portfolio re-evaluation was necessary. Clearly, portfolio clean-up and significant risk reduction is prudent to rebuild and stabilize financial industries; however, questions remain whether credit-worthy SME customers with standing banking relationships were dropped or phased-out of foreign-owned portfolios due to an inability to meet transaction-based criteria. Further, questions remain regarding the extent to which such SMEs were able to obtain new banking relationships with remaining or *de novo* domestic banks. Further research is necessary to determine whether these short-run disruptions existed, whether they had a significant effect on the viability of affected SMEs in Latin American EMEs, how long they took to resolve themselves, and levels of attrition. To appropriate a Keynesian metaphor: How many SMEs lived to see long-run benefits of FSFDI? A thorough assessment would require access to reliable panel data that also tracked the identity of firms, making it possible to follow their movement over time. A substantive amount of qualitative data in the form of interviews with both banks and SMEs would be necessary to establish the explanation for why firms were or were not phased-out, for example, profitability issues or a lack of sufficient information.

To this writer's knowledge there are no existing studies that have used data of this nature to assess this question. Certainly, it is plausible to assume that there are cases in which SMEs are phased out of existing lending relationships for lack of sufficient quantifiable data; it is equally plausible to assume that when this occurs, it is highly costly for affected firms. For these reasons, further research on this subject is warranted.

Cardenas et al. (2003) argue that foreign subsidiaries improve the conditions of acquired Latin American EME banks by "drastically overhauling portfolios." Schulz (2006) also discusses how theory suggests that asset qualities of acquired banks improve through the transfer of credit workout schemes and risk management techniques from home markets, resulting in lower risk portfolios. Berger et al. (2001) assert that distressed banks may 'cut-off' informationally opaque firms.

A paper commissioned by the Bank of Canada studied the experience of two major Canadian commercial banks, Scotiabank and CIBC. Both of these institutions have multi-national operations with investments in various Latin American EMEs (Murray, 2004) and are thus exemplars of FSFDI. The study finds these banks to be highly risk averse (Murray, 2004). In order to maintain the desired low-risk profile, a number of checks and balances are put in place. Scotiabank's formula, for example, involves sending all credit decisions back to their Canada-based headquarters specifically to avoid local decision-making biases (Murray 2004, 7). This can be interpreted to mean that Scotiabank wants to ensure that loan officers are not relying on 'relationship-lending' type information to make lending decisions. CIBC also cited concerns that local loan officers were too "optimistic" when granting credit, though the report does not outline their mitigating strategy (Murray 2004, 4).

The cases of Scotiabank and CIBC suggest that clients, who previously relied on relationship-based lending, would likely be unable to meet new transaction-based criteria if asked to provide it. In this instance it is plausible that they would be deemed ‘high risk,’ and phased-out as part of any loan restructuring that either bank was involved in. We already know that SMEs rely relatively more heavily upon ‘relationship-based’ lending and would therefore be the most likely of any pre-existing clients to encounter difficulties in having their loans renewed for lack of sufficient information. Admittedly, given the banking sector’s reluctance to share data on such decision-making processes, it would be extremely difficult to confirm that this phase-out process takes place; however, on the basis of the foregoing it seems plausible and worthy of further study. To recap, potential methods of inquiry could include repeated surveys of small, medium, and large-scale enterprises and lenders both before and after the takeover of a domestic bank. This would help determine the extent to which firm size and its use of relationship rather than transaction-based lending affected its ability to retain a relationship with the bank.

The Potential Costs to SMEs of Losing a Credit Relationship

The discussion of relationship-based lending specifically noted that the bank-borrower relationship gains additional value over time. It is difficult to ascribe a precise quantifiable value to the information that is accumulated; however as discussed earlier, it is at least partially reflected in the reduction of interest rates, access to larger loans, lower collateral requirements and fees. SMEs that lose such a relationship with a lender lose all of the intangible value inherent within it because the value is non-transferable. A number of writers, notably De Soto (2000), have highlighted the difficulties that entrepreneurs in emerging markets face in securing collateral for credit; standing relationships constitute social capital in a very real and tangible sense, and the effects of their loss should not be underestimated.

A loss of credit can pose serious impediments to firm survival. Firms rely on working capital loans to finance receivables and inventory during the business cycle. Extended or complete withdrawal of this type of credit could, depending on the business, lead a firm to encounter problems with paying suppliers for goods necessary to fulfill contracts and purchase orders. Depending on the length of time associated with the disruption, firm survival could be a concern. Finally, establishing a new banking relationship also implies additional costs separate and distinct from those mentioned above. Search fees, new loan set-up fees, collateral registration and legal fees are all part of the costs borne by a firm while establishing new credit with a bank (Berger, et al. 2001). In addition to the loss of the intangible ‘relationship’ and its accumulated stock of information, costs associated with disruption, search, and set-up, must also be factored into the equation. In summary, for SMEs, which are *ceteris paribus* undercapitalized when compared with larger firms, displacement from an existing lender and the process of finding and establishing a new lending relationship pose significant costs and represent potential threats to firm survival. Again, the extent to which the process of adjustment actually takes place post-FSFDI requires substantiation; however, at minimum it is implied by some of the literature. Certainly, the potential costs as outlined are substantial enough to merit further investigation.

ANALYSIS

There are a number of implications that stem from the arguments presented. Notwithstanding the question of the net effect of increased FSFDI on SME access to credit, it is clear that information opacity and SMEs' reliance on relationship-based lending act as serious barriers to credit. Under certain conditions, these obstacles are aggravated by an influx of FSFDI. Moreover, even in cases in which SMEs gain increased access to credit due to domestic banks developing SME niches—to the extent that the banks must rely on these lenders to obtain financing, they may be at a disadvantage compared to larger firms capable of accessing foreign-controlled banks. In cases where domestic banks are less efficiently managed, such inequality will tend to persist until reforms are made.

It is ironic that as banks become more sophisticated, they tend to move from more relationship-based to more transaction-based lending practices. SMEs that rely on relationship-based lending will thus continue to suffer, forced to find sub-optimal domestic banks to obtain credit. It is therefore necessary to overcome some of the constraints of information opacity by supporting the development of financial infrastructure such as credit bureaus that SMEs may register with, while concurrently fostering competition within the financial sector so that there are market incentives in place to encourage the development and entry of new domestic banks that will develop SME lending niches. To prevent the emergence or persistence of duality in the financial sector, competition is also necessary to force domestic banks to improve their management practices, specifically their credit granting policies, risk management techniques and levels of human capital; otherwise they will continue to operate sub-optimally. As this process unfolds it will be crucial for the government to provide the necessary institutional tools and support to SMEs, as discussed above, so that they may reduce their reliance on relationship-lending. In summary, initiatives focused on both macro as well as micro-economic reform and support is required concurrently.

Policies aimed at reducing the costs to SMEs when they are forced to switch lenders seem more limited. The ideal way to reduce such costs is to avoid incurring them; in other words, minimize the number of SMEs that rely solely on relationship-based forms of information. In addition, strengthening domestic banks may assist those SMEs that are ultimately forced to switch by broadening both the quantity and the quality of the lending options available to them.

Admittedly, during any process of adjustment when non-efficient industries transition to efficient market-based systems, short-term costs are necessary for medium to long-term efficiency gains. Therefore, a final observation is that the costs to SMEs will likely be greater in the short term; however, if broad ideas such as the ones outlined above are developed into effectively executed policies sooner rather than later, they would likely mitigate the magnitude of harm done to SMEs' prospects for accessing and maintaining credit in the context of rising FSFDI. Ideally barriers fall more than they grow, allowing efficiency gains to trickle down to more firms in the economy.

CONCLUSION

This article provides a critical commentary on the literature surrounding the effect of FSFDI on the SME market for access to financing. It starts by critiquing a study by Clarke et al. (2002), which uses cross-country data to argue that FSFDI bring benefits to all firms. The authors argue that FSFDI creates efficiency gains in the financial sector that result in an expanded pool of credit, at reduced prices. Further, Clarke et al. theorize that when foreign firms poach larger, more sophisticated clients, domestic banks may develop SME lending niches; hence, SMEs also benefit from FSFDI for this reason. This article highlights the problems with this and other studies. Methodologically, it highlights the difficulties with relying solely on cross-country data from borrowers who already have access to credit. More fundamentally, barriers to credit for SMEs, often derive from the banking sector's requirement of quantifiable, standardized forms of information that many smaller, semi-formal firms do not have. Consequently, researchers and policy makers need to look more closely at the basis upon which banks grant credit, be it transaction-based lending or relationship-based, rather than simply looking at the price and quantity of funds lent. If increased FSFDI simply translates into a move toward more transaction-based lending, then, in the short-run, barriers to credit for informationally opaque firms may actually rise, *ceteris paribus*.

Noting the mini case study of Mexico, this article demonstrated that competition may be a crucial variable in enhancing the likelihood that domestic banks service SME niches. However, the potential inefficiency of domestic banks as sources of credit calls into question how desirable they are as alternative lenders. Improvements to internal credit and management practices are necessary to increase the ability of these institutions to service SME clients, among others, effectively. Finally, a more thorough examination of the dynamics involved with FSFDI is warranted. Looking at whether or not SME clients with standing banking relationships are forced to switch lenders post-FSFDI is critical if one is to effectively measure its costs to this sub-sector of firms.

Policy must be directed towards improving the market conditions within which SMEs operate. Institution building that assists SMEs in overcoming the problem of information opacity may not assist in increasing access to loans with foreign-owned banks. It may however reduce the likelihood of SMEs being phased-out of existing relationships and enhance access to better managed domestic institutions with skilled lenders. This is not to say that domestic banks should increase efficiency through a move to transaction-based approaches, but to assist those domestic banks which have chosen to target SMEs as clients to be in a position to provide higher value service to them. Promoting competition in the financial industry is another way to encourage enhanced financial services to all sectors of the economy, including SMEs, and is therefore an important sister policy to institutional strengthening.

NOTES

[1] This type of capital and technology acquisition must be sharply contrasted with the type that occurred during the neo-liberal reform period. The reforms caused technology and capital acquisitions to leap frog the capability sets available in the economy. In the SME example, the slower progression of capital acquisition, often coupled with on-the-job training and/or increases in education and skills training may only occur over the medium-term.

[2] For this statistic the data provided by Jenkins (2000) did not disentangle which banks were private and which were state-owned, however, given 98 banks were private, it is known that at least a portion of the 88 were private.

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