Supply Chain Finance in Canada: A Solution for Credit Market Gaps?

The current state of SCF in Canada suggests elements of credit market failure are at play. The common view is that financing gaps, especially for smaller companies, arise when companies are unable to obtain as much debt as they request. Riding and Belanger note that these credit shortfalls are not evidence of financing gaps, as not all applications for credit should be granted. [41] The OECD further notes that the "supply of credit is not inexhaustible" and that some borrowers will be turned down due to the normal operations of credit allocation within capital markets.[42] Riding and Belanger succinctly summarize the literature on what constitutes a credit market gap:

1. among loan applicants who appear identical, some receive credit while others do not; or,
2. there are identifiable groups in the population that are unable to obtain financing at any price.

Empirical studies and surveys indicate financing gaps do exist in Canada and elsewhere.[43] Credit rationing affects smaller and new firms more so than larger firms and can be viewed as a natural state of affairs resulting from gaps in the credit markets.[44] As a firm grows in size, its access to credit becomes easier and less costly. The end result is smaller firms have less capacity to take advantage of growth opportunities. The evidence further suggests this outcome is more pronounced for exporters.[45]

Economic theory argues that market gaps arise in the presence of information asymmetries and externalities. Information asymmetries occur when the borrower (e.g. small company) and lender (bank) do not share the same information. In the case of financing, banks often lack complete information on companies' credit profiles, leading to restrictions on lending. Externalities refer to situations in which a cost or benefit is borne by parties outside the activity. A positive externality occurs when the activity being undertaken provides benefits to third parties. In such cases however, the good or service will be underproduced. The producer will only supply enough to maximize its own internal profits, which means that all of the benefits that could have accrued to third parties are not fully realized.

In the past few years, supplier payment programs have become largely synonymous with what most people consider to be a SCF program. The discussion here therefore focuses on supplier payment programs. A study on SCF by the Bank of England notes two key characteristics of these types of programs.[46] First, the buyer (not the lender) takes responsibility for the supplier (e.g. quality of goods, return of faulty goods, etc). Second, the cost of financing for GVC participants is based on the credit rating of the buyer and not the individual suppliers. The deployment of SCF programs can therefore address some

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[41] Allan Riding and Brad Belanger (2007), "Minding the Gap: Assessment of Financing Gaps Related to SME Exporters in Canada", University of Ottawa School of Management and Industry Canada.

[42] OECD, "The SME Financing Gap, Volume 1: Theory and Evidence", 2006.

[43] *Ibid.* and Hall, Peter and Todd Evans, "Minding the Gap: An EDC Assessment of Financial Intermediation Gaps in Canada," Export Development Canada, 2005.

[44] OECD, International Conference on SMEs, Entrepreneurship and Innovation, Issues Paper, 2009.

[45] Riding and Belanger, *op. cit.*

[46] Bank of England, "Supply Chain Finance", Report of the Supply Chain Finance Working Group, July 2010.