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SMEs Financing: the Extent of Need and the Responses of Different Credit Structures

Daniel BĂDULESCU
University of Oradea
daniel.badulescu@gmail.com

Abstract. *Small and medium enterprises (SMEs) have a key role in developing national economies, but are often limited by lack of development support in financing business for reasons of information asymmetry, high risks, lack of collateral, unfavorable regulatory environment. The statistics show managers given constant importance of SMEs financing opportunities, bank credit pre-eminence over other forms of financing, the lack of viable alternatives for start-up and innovative companies, etc. Market concentration, alternative between transactional or relational lending, various types of banks; state owned, private owned, foreign, large or small, are analyzed to identify the availability for SME financing. Finally, it is recognized the importance of a diversified banking markets both in terms of supply, lending technologies, but also as bank institutions itself.*

Keywords: SME; financing; transactions lending; relationship lending; banks.

JEL Codes: G32, M13.
REL Codes: 11C, 14K.

Introduction

Small and medium enterprises (SMEs) play an essential role in the development of any country. They can be assimilated as the engines of growth in developing economies, and the importance and future of SMEs tend to be a major policy concern, with strategic importance in reshaping the productive sectors, employment and innovation. But, in order to accomplish all this expectations, we have to admit that one of the biggest problem the SMEs faces is the non-availability of adequate financing facilities, the lack of availability of financial institutions or private equity investors to meet the SMEs financing requirements.

Banks, like other businesses, concentrate on creating value under a controlled risk (OECD, 2006, Pathrose, 2005). Analyzing a loan application, a bank has to focuse on the risks involved and the methods to mitigate those risks. The banks are reluctant to lend to SMEs for a number of reasons, including the following:

- The information asymmetry that arises from small businesses' lack of financial information and standardized financial statements, in addition to the bank's limited knowledge about the borrower company (Badulescu, Badulescu, 2010). The quantity and quality of the information hold by the entrepreneur regarding their business cannot be accessed in the same measure and efficiency by the prospective creditor. Thus, the lenders is unable to separate between good (bankable) projects and doubtful projects, and the price (for example, the interest of the loan) doesn't make an efficient selection; rather it will increase the bank credit portfolio with risky loans: some of them with interesting perspective, others failures for sure (this phenomenon is the adverse selection). The second issue created by informational asymmetry is the moral hazard: once the loan granted, the control of its use according to the original application (and the risk and opportunity analysis) could face serious difficulties and the loan could be used – even part of it – for other purpose. In order to reduce this risk, the financer will ask as guarantee collateral: assets, receivables, personal goods, immovable, or will pretend the early repayment of the loan, or, if it is possible, will restrict the access on the rest of unused loan.
- The high risks involved in lending to the SMEs as a result of limited assets that can be used as collateral, high failure rates, low capitalization and vulnerability to market risks. The finance institutions consider the environment of SMEs being competitive and very uncertain (compared to large companies), implying a high variability

of return of similar SMEs in the same sector, and finally high failure rate. The limited power in market, considerable share of intangible assets, lack of relevant financial and commercial track records, insufficient circulating assets or tangible fixed assets tends to create a higher risk profile of SMEs for potential investors (OECD, 2004, Lin, Sun, 2006, Toivanen, Cresy 2000, OECD, 2000). Insufficient collaterals compared to the lenders' request in order to overcome the risks associated to moral hazard is probably the most claimed cause of the difficulties in accessing a credit by a SME. The collaterals' insufficiency can be the expression of an incipient stage of the business, unconsolidated yet, up to an exaggerated sizing of the credit request, upon the firm real capacity to sustain the project.

- As small businesses cannot offer adequate collateral, the banks are unable to determine whether the borrower possesses the technical, managerial and marketing skills to generate adequate cash flows and service the loan. The SMEs are characterized by unsatisfactory technical endowment, difficulties in assuring qualified technical staff and experimented management (human capital) in order to adapt to the multiple and rapid changes of present-day economy. At least, the reports accuracy, business protection under contractual basis is precarious, even for internal or external reasons; make barriers for the financial institution in order to compute the real profitability of the company, the repayment capacity, even the reliability of some collateral. In developing countries, the risk profile is supplementary marked by the unstable legislative and competitive environment, with negative consequences on the transactions security.

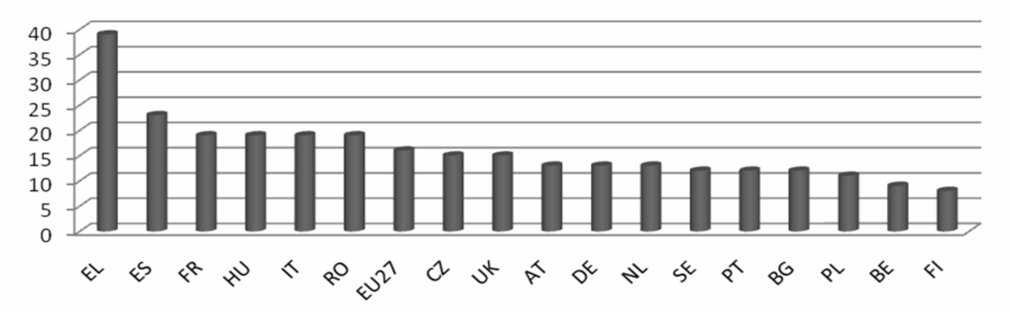
1. The size of financing needs and the prevalence of bank loans

Based on a recent research - Flash Euro barometer Access to finance (No. 271), commissioned by the European Commission's DG Enterprise and Industry, in cooperation with the European Central Bank (ECB), to measure EU companies' use of various sources of finance, the difficulties in accessing finance, we notice that one of the most pressing concern of SME managers from EU is access to financing, adding more than 16% from answers (after *finding customers* but far away of *the competition* or *availability of skilled staff*) (European Central Bank, 2009, Gallup Organization, 2009).

Source: ECB (2009).

Figure 1. *Companies' most pressing problem*

As expected, inside de EU there are significant differences between countries, for example very important for SME in Greece (39%) and Spain (23%) or Romania (19%) but moderate for Poland, Belgium SMEs (see Figure 2).



Source: ECB (2009).

Figure 2. *Companies identifying acces to finance as the most pressing problems*

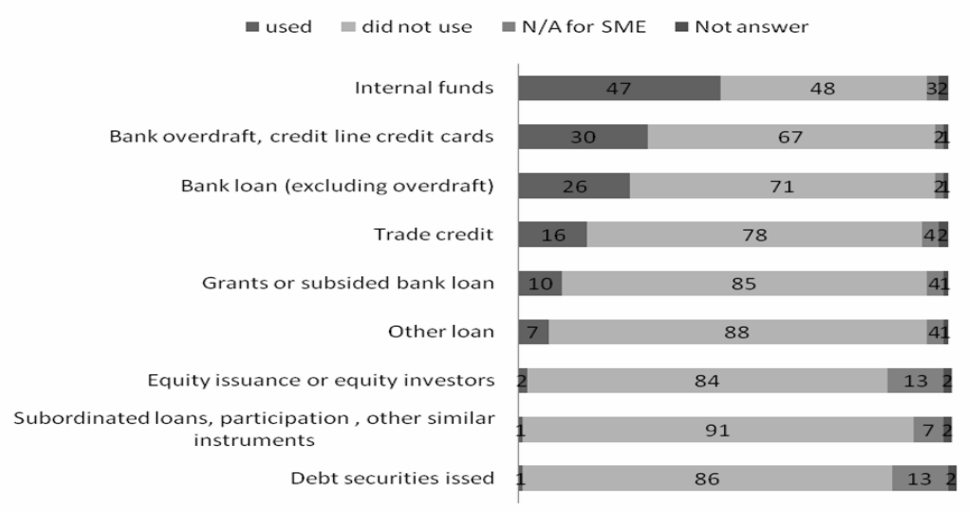
Regarding the profile of companies we notice that the "access to finance" was more often selected as the most pressing problem by managers of companies with a turnover of less than €10 million (16%-17% vs. 8%-10% for companies with a turnover above €10 million), established between two and nine years ago (20%-21% vs. 12% in companies established less than two years ago and 14% in companies existing for 10 years or more), in the construction sector (20% vs. 14% in the services sector and 17% in trade and industry or that have introduced innovation in at least one area – products or services, marketing, production and management (18% vs. 14% in non-innovative companies).

Almost half (47%) of managers in the EU answered that they had used internal funds in the past six months to finance their operations (as seen above – some had only used internal funds, while others had used these in combination with external financing).

The most popular source of debt financing was a bank: 30% of companies had used bank overdraft facilities or a credit line and 26% had received a bank loan. Debt can also be issued by a public source or even a friend or family member: 10% of interviewees referred to grants or subsidized bank loans and 7% mentioned “other loans”. A few (1%) managers said they had used a subordinated loan, participation loan or similar financing structures.

Other financing forms as leasing, factoring or hire-purchasing were preferred by 23% from managers and 16% said they had used trade credit as a source of short-term financing. Regarding debt securities issuing, in the past six months, the majority of managers considered this type of financing not to be relevant for their needs.

Equity issuance or external equity investments were mentioned by 2% of managers as one of the sources of external financing they had used in the past six months (European Central Bank, 2009, Gallup Organization, 2009).



Source: ECB (2009).

Figure 3. *Internal and external sources of financing for EU SMEs (2009)*

The chart above shows the importance for the companies of the bank lending products (as debt financing, overdrafts, working capital line or other credit loans) in the past six months, as another source of external financing – i.e. equity issuance, equity investors, debt securities are very low utilization. Looking at company characteristics, we can see that micro-companies (with less than 10 employees) were the most likely to use only internal funds in the past six months but, while, increasing the staff, a company is determined to use an external financing instruments.

Regarding the sector of activity, we can notice that businesses in the industry sector were more interested to use both internal funds and external sources of finance in the past six months. Also, innovative companies were more active to seek and combine internal and external financing sources comparing with non-innovative ones (37% vs. 31%). On the other hand, the new-established companies (active for less than two years) were the most likely to have only used internal funds to finance their operations (22% compared to 14%-17% for longer-established companies) (European Central Bank, 2009, Gallup Organization, 2009).

2. Financial institutions structure and lending to SMEs

While SMEs trust regularly on bank financing is important to know what kind of market structure is more suitable for SME financing. The analysis of SME financing, various theoretical studies or empirical evidence provides a considerable quantity of information regarding relationship between structures of the financial institution, technologies, management. Moreover, recent researches (Berger, Udell, 2004, Beck et al., 2010) try to show some distinction between lending technologies versus relationship lending to understand the very different transactions technologies, focusing on the comparative advantages of different types of financial institutions in using transactions lending technologies versus relationship lending (Berger, Udell, 1996, Miller, 2003, Berger, Udell, 2004).

For our purpose, briefly we can define *transactions lending* as a banking technologies primarily based on "hard" quantitative data that may be observed and verified at about the time of the credit origination. This hard information may include: financial indicators computed from financial statements; credit scoring based on historical data provided by bank database, or SME itself, credit bureaus records; collateral registrations, or other information about solicitors from transparent sources (suppliers, payment incidents, external ratings, etc.). The main characteristic of this type of information is that it is relatively easily observed, verified, and transmitted through the communications channels within the financial institution.

On the other hand, *the relationship lending* technology is based mostly on "soft" qualitative information provided by certain specialized persons, through a long, continuous, often discrete but intuitive contact over time with the SME owner, manager or company's staff, or with members of the local community. The soft information may include the character and reliability of the SME's owner based on direct contact over time by the institution's loan officer; the payment and behavioral history of the SME regarding loans, cheques, deposits, other services to the SME by the institution; or the future prospects of the SME based of various data from SME's suppliers, customers, or neighboring businesses, local authorities or community. The soft information is given both by to the loan officer or other banking staff, but in general it may not be easily observed or verified by others risk managers, or inside bank deciders, especially when they received this information through communications channels within the financial institution (Berger, Udell, 2004).

2.1. Does market concentration affect SME's lending efficiency?

Several studies generally showed that a greater market concentration often result in a diminishing of credit access through any lending technology (Berger, Demirgüç-Kunt, Levine, Carlson, Haubrich, 2003). This comes about no mater of size, owner or country origin of parent bank but simply because the main financial actors in more concentrated markets may exercise greater market power. These institutions will choose to preserve or even increase their profit not only by an efficient activity or more flexible approach of SME requirements but through rising interest rates or fees on loans to SMEs. These institutions can be less interested innovation or in quality of service to the clients, based mainly on their sure position and power on the market. The banks can reduce the risk or implication in portfolio monitoring simply through tightening credit standards for SMEs. Some studies (Sharpe, 1990, Petersen, Rajan, 1995) show that this market power encourages the bank institution to press on a long-term implicit contract in which the borrower receives a lower interest rate in the short-term, but after a period the bank uses by its discretionary right to rise the costs of the loan (variable interests, advance repayment fee, administration fee etc) forcing the borrower to pay a higher-than-competitive rate in a later period.

2.2. What kind of bank for SME's lending?

2.2.1. Are domestically-owned banks more interested in SMEs financing compared to foreign owned banks?

On the first sight, foreign-owned institutions may have comparative advantages in SME technologies lending and domestically-owned institutions may have comparative advantages in relationship lending (de Haas, Naaborg, 2005, Berger, Udell, 2004). This assumption can be explained by following reasons:

- Foreign-owned institutions are part of large organizations, and these behavior can be assimilated with specific typologies of big banks actions on the market;
- Foreign bank has often difficulties in processing and transmitting soft information over greater distances, through more managerial layers. Furthermore, they have to deal with multiple and different economic, cultural, language, and regulatory conditions environments which affect the relationship lending aspects;
- Small and domestic banks are more suitable to finance SMEs because they are better engaged in "relationship lending", a type of financing based on "soft" information collected by the loan officer having continuous, personalized, direct contacts with SMEs, with their owners and managers, and the local community;
- On the other hand foreign-owned institutions settled in developing economies may have additional advantages in transactions lending to some SMEs because they have a better access at information technologies for collecting and assessing hard information, cheap funds or greater expertise, even training for loan officer and risk managers in their headquarters.

Some recent researches (Beck, Demirgüç-Kunt, Martinez, 2010), for a better understanding of the SME financing, tackle from the supply side using cross-country data, instead of large literature based of demand supply position. Based on an impressive collection of analyzed data(1) the results show significant differences across ownership types in lending technologies and organizational structures:

- Foreign banks are more likely to use hard information relative to private domestic banks. The share of secured SME loans is higher among foreign banks than domestic banks.
- Compared to domestic banks, foreign banks tend to be least likely to decentralize loan decision making and risk management, confirming the assertion that foreign banks use different lending techniques and organizational structures to reach out to SMEs.

In spite of all these different approaches, the results show that different lending techniques and organizational structures lead at similar results in terms of SME lending. Most notably, the researches find no evidence that foreign banks tend to lend less to SMEs than other banks. The conclusion of these studies is that different bank types, applying different lending technologies and organizational structures, can play an important role in financing SMEs, in developing economies.

2.2.2. What kind of banks are more efficient in the relationship with SMEs: state-owned banks versus private-owned banks?

State-owned institutions may have comparative advantages in transactions lending comparing with privately-owned institutions which try to obtain comparative advantages in relationship lending, but these cannot always transform in an advantage. The explanation came from various evidence as:

- In general, state-owned institutions are larger than private local banks (excepting private foreign banks), but this dimension often prolongs/ extends communication channels and negative affects network efficiency;
- State owned- banks generally operate with government subsidies and often have mandates to supply additional credit to SMEs or specific industries, sectors, or regions. Apparently, this can be an advantage, both for banks or SME, but, in reality, the effects on SME lending are unclear or even an opposite effect. For example, some fund goes to SME unable to repay the amount at maturity or are not creditworthy, but are supported by different political or local power. In other case, these funds, instead to finance new, profitable business, based on strong cash flow, positive net present value projects are designated to repaid former credit, some of them in difficulty;
- State-owned institutions may also perform inconsistent credits monitoring and avoid a firm, steady policy of collection (or forced execution) procedures, because of lack of market discipline.

2.2.3. Large banks or small banks?

In the first stage we can admit that large bank institutions may have comparative advantages transactions lending technologies which are based on hard information and small institutions may have comparative advantages in using the relationship lending technology which is based on soft information.

Referring on scale economies the large bank could take advantage from hard information processing, but disadvantaged in processing soft information because the difficulties to quantify and transmit this kind of data through the long communication channels. This may give comparative advantages in relationship lending to small institutions with lower administration costs, a less distinctive separation between ownership and management and fewer levels of management (Stein, 2002, Berger, Udell, 2002).

Finally, it is often argued that large institutions are relatively disadvantaged at relationship lending to SMEs because of organizational diseconomies, so this large bank prefer to enter in loan transaction and other wholesale services with large corporate customers. The empirical literature on this topic usually based the conclusions from the characteristics of the SME borrowers and contract terms on credits contract between SMEs and banks of different sizes (Berger, Rosen, Udell, 2003):

- Large bank institutions are found to lend to larger, older, more financially secure SMEs, often argued that large institutions lending prefer borrowers with a clear implemented corporative governance,
- Large banks are found to promote lower interest rates and obtain lower yields on SME loan contracts comparing with small institution which explained this differential through flexible, non bureaucratic and rapid procedures in credit assessment(Berger, Rosen, Udell, 2003, Berger, 2004);
- Small banks are found to have more longer, privileged and personal relationships with their SME loan customers, comparing with larger banks, based on long distance, impersonal and short terms of their relation with customers, appreciated as weaker (Berger, Miller, Petersen, Rajan, Stein) and often unsatisfactory for a better loan decision;
- Large banks institution appear to base their SME credit decisions more on strong financial ratios than on relationships.

3. Conclusions

The present paper try to offer an analysis of the role of different types of financial institution, their availability for SME lending , removing the opaque characteristic of this sectors on risk assessment, and a better acknowledgment of reasons and particularities, both from principal actors but from regulation and legislative framework, infrastructure etc.

First, financial institution structure – the presence in the market of different types of institutions and the competition among them – may have important effects on SME credit availability because institutions of different types may have comparative advantages in different lending technologies. The lending infrastructure – the information environment, the legal, judicial and bankruptcy environment, and the tax and regulatory environments – may directly affect SME credit availability.

Second, the presence of foreign-owned and state owned institutions, as well the presence of large and small institutions and the measure of financial institution concentration are elements that may affect SME credit availability through comparative advantages in the different lending technologies. In particular, a greater presence of foreign-owned institutions and a lesser presence of state-owned institutions are likely to be associated with significantly higher

SME credit availability in developing nations because foreign-owned institutions appear to have advantages in some of the lending technologies, and state-owned institutions appear to be generally disadvantaged.

Third, the result of our research strongly suggests that "better" lending infrastructures may make significant differences in SME credit availability directly through facilitating the use of the various lending technologies. A careful and restrictive regulatory environment may influence the financial institution structure, preventing some types of financial institutions to gain sufficient market shares in order to capitalize their comparative advantages in specific lending technologies and use in their interest the relative market power. It is the case of many developing countries in last decades that trying to reduce the considerable market share of state banks in favor of more efficient privately-owned institutions has to face now with particular problems generate by a very large presence of foreign owned bank in their banking sector.

Finally, we consider that a well balanced structure of banking sector, with important state banks, involved in large national projects, dynamic and flexible small private banks, closed to relationship lending, and a provocative foreign bank presence can exploit all opportunities on the economies, creating a large base for meeting SME financing requirements.

Note

(1) Survey data from 91 large banks of different ownership types across 45 countries.

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