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SMEs FINANCING – AN OVERVIEW OF DIRECT FINANCING ON CAPITAL MARKET VS. FINANCIAL INSTITUTIONS

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Abstract: *The importance of the role played by SMEs in the global economy and their contribution to job creation, added value, innovation and growth is widely acknowledged, therefore it is extremely necessary to support their development. In order to be competitive, SMEs also rely on external financing, not only through financial institutions but also through direct participation in the capital market. Managers place great emphasis on financing their businesses, and most of the European companies relying primarily on bank loans as their most important source of founding, unlike in the United States of America, where the activity of stock exchanges is much more developed. This paper aims to study a shared analysis of the advantages and disadvantages of SMEs in Romania regarding financing through financial institutions vs direct participation in the capital market.*

Keywords: SME, bank financing, capital market

JEL classification: G15, G21

1.Introduction

The financing of SMEs, the engine of the economy, both on the capital market and through the banking system, has numerous benefits for the entrepreneurial environment and implicitly for the economy. SMEs request financing for investments or working capital, which leads to business development, and a developed business environment leads to a developed economy. Precisely because of this, the attention of governments around the world is turning towards SMEs and entrepreneurs, and towards the way in which they can be supported to become stronger and more sustainable.
The economy is in a continuous dynamic; the sources of financing are varied. This paper aims to study SMEs' access to financing from the perspective of intermediaries (financial institutions) and direct access to financing (capital market). The ways of financing SMEs differ depending on their type: micro-enterprises, small and medium-sized enterprises. In addition to the distinction of size, there are other characteristics, including seniority and the sector in which they operate, that require different approaches.
The distinction between different segments among SMEs is also important in terms of their financing needs and the different options to ease their financing constraints. Informal micro-entrepreneurs appear to be the 'ideal' clients for micro-financing institutions, which rely on community ties and 'informal types' of collaterals for their

loans (Beck, 2013). Many mid-sized businesses, on the other extreme, may be candidates to look beyond the banking system to capital market types of financing, including private equity funds or even listing on the stock exchange. The intermediate segment, “small” enterprises, seems to be the most complicated, as they are often limited to banks as their only provider of formal financing.
The capital market represents one of the pillars of a developed economy and contributes to the development of a healthy economic enviroment. The main role of the capital market in the economy is to provide financing for companies that need additional capital and to facilitate the transfer of available capital from investors to companies that intend to capitalize through the capital market. Private companies began to increasingly consider attracting financing from the capital markets at the expense of other sources of financing, an aspect that, in the long term, can result in the achievement of a general economic balance (Caraganciu, et al, 2005, p.10).
The paper is structured as follows: the first part contains introductory remarks regarding the importance and relevance of the topic addressed; the second part is dedicated to literature review that summarizes the main research undertaken so far on this topic and emphasizes the development of SMEs through accessing external financing represented by financial institutions and the capital market; the third part of the paper contains a comparative analysis of the advantages and disadvantages that SMEs have by accessing the financing offered on the two markets: the banking market and the capital market. The study ends with conclusions.

2. SMEs and the access to financing on the banking market and the capital market – literature review

If one takes into account SMEs’ contribution to economic growth, supporting their development becomes obviously important. One of these channels through which SMEs contribute to economic development is that of creating new jobs. Recent cross-country survey evidence suggests that smaller firms not only provide the most jobs worldwide (Ayyagari, Beck, & Demirguc-Kunt, 2007), but also create more jobs than larger firms (Ayyagari, Demirguc-Kunt, & Maksimovic, 2011). However, according to Beck (2013), it is rather difficult to draw a clear result from this study.
There is significant evidence that financial development can contribute to job creation, and there is evidence that this is partly through the expansion of SME financing.

2.1. Constraints in SMEs’ financing

Regarding access to bank financing, Beck (2013) identifies four problems. A first type of access problem is caused by demand. This problem can be highlighted by too few loan applicants simply due to self-exclusion resulting from cultural barriers or financial illiteracy. A second type of access problem may arise from regulatory distortions or insufficient contestability that cause lenders not to fully exploit all communication opportunities and thus settle at a point below the access possibilities frontier. A third access problem is associated with “excess access,” that is, an equilibrium above the affordability frontier, with loans extended to a higher share of borrowers than is prudently justified. A final access problem is a too-low level of prudent access possibilities, caused by weaknesses in an

economy’s institutional framework compared to that of countries with similar levels of economic development.
For each of these problems, Beck (2013) offers solutions by referring to the specialized literature and empirical studies carried out in various countries. The first – demand-driven issues – calls for demand-side measures that educate and encourage healthy use of financial products by SMEs. While the specilized literature has traditionally focused on supply-side constraints, during recent years more studies of financial literacy for entrepreneurs have been seen. According to empirical studies conducted in various countries including Bosnia and Herzegovina (Bruhn and Zia, 2013), Peru (Karlan and Valdivia, 2011), Dominican Republic (Drexler, Fischer and Schoar, 2010), Sri Lanka (De Mel, McKenzie and Woodruff, 2012), Pakistan (Gine and Mansuri, 2011) and Central America (Klinger and Schündeln, 2011), there is a wide variation in findings, with the general conclusion being that tailored interventions can have an impact on entrepreneurship and business expansion under certain circumstances. The second issue requires interventions and policies that encourage financial institutions to maximize the achievement of SMEs’ potential in the existing contractual and macroeconomic environment. Conversely, restrictive measures may be requested when loans are granted to a number of applicants in excess of what may be considered prudent. The last type of problem, too little prudential access, requires a set of policies that provide for general reforms of the business environment and institutional framework that are not specific to the SME credit market.

2.2. The effect of the structure of the banking system in SMEs financing

Across the globe there is great variation in the market and ownership structures of the banking system. On the one hand, there are many small and concentrated banking systems, especially in low-income countries, with often fewer than ten banks; on the other hand, Germany has several hundred small banks that operate locally. The structure of the market may change over time. Ownership structures also vary significantly across countries, with a few countries still relying heavily on government-owned banks, others having mostly domestic private banks, and others relying mostly on foreign ones, such as in many Central and Eastern European countries (Claessens and van Horen, 2014).
Both the specialized literature and the empirical studies are ambiguous about the effect of the market structure and the banking sector competition on accessing financing. While the traditional view of market efficiency holds that more competitive markets are conducive to accessing external financing (Pagano, 1993), others point to market power as providing the necessary incentives to establish long-term lending relationships (Petersen and Rajan, 1995).
Cetorelli and Gambera (2001) show that industries where young firms rely more on external financing grow faster in countries with more concentrated banking systems. Beck, Demirguc-Kunt, and Maksimovic (2004) show that barriers to accessing SME financing increase with banking concentration, but only in countries with low economic and institutional development. Carbo-Valverde, Rodriguez-Fernandez, and Udell (2009) find that greater competition improves credit availability for SMEs in Spain.
Related to the issue of market structure is that of bank size. It has often been assumed that smaller banks, with flatter hierarchies and shorter distance between the borrower and the final loan decision maker, are more favorable for small

business lending because they are more efficient at processing soft information (Berger and Udell, 1995; Stein, 2002).
Sapienza (2002) and Berger et al. (2005) confirm this hypothesis with data for the United States. Canales and Nanda (2012), on the other hand, show in the case of Mexico that more decentralized banks are more likely to make larger loans to small businesses, but are more likely to exploit their market power in concentrated markets. Looking beyond banks, Beck, Demirguc-Kunt, and Singer (2013) show that small-scale financial institutions that specifically target SMEs are not necessarily more efficient than large institutions.
The issue of market structure is also related to that of bank ownership. Foreign bank ownership has been particularly controversial in terms of its effects on SMEs' access to external finance. On the one hand, cross-border banks can help promote improved corporate governance, by bringing much-needed technology and experience, which should translate into increased efficiency of financial intermediation in small host countries. There is mixed evidence on the effect of domestic market penetration of foreign banks on SMEs' lending. On the one hand, evidence from firms suggests that firms report lower financing obstacles in countries with a higher share of foreign banks, a finding that holds for groups of firms of various sizes (Clarke, Cull, & Martinez Peria, 2006). Foreign banks bring the necessary know-how to implement new lending techniques. Mian(2006), Gormely (2006) suggest that foreign banks are much less willing to lend to small and opaque SMEs than domestic banks. Claessens and van Horen (2014) and Bruno and Hauswald (2008) show that foreign bank penetration has a positive effect in countries with more effective credit information sharing and creditor rights protection systems.

2.3 The link between lending techniques and SMEs' access to financing

Closely related to the debate on the market and ownership structure, the lending techniques that are most appropriate for SMEs are also studied. The traditional view of SMEs financing focuses on relationship lending.
Long-term relationships between a financial institution, or even a specific loan officer, allow for the overcoming of the risks generated by information asymmetry problems. The focus on relationship lending that underpins SMEs' financing shows that smaller, local financial institutions are more effective in lending to SMEs than large, foreign-owned banks.
According to the empirical studies presented in his paper, Norden (2015) concludes that relationship lending works and customers rely on it to obtain larger loans and lower interest rates. Furthermore, the existing competition between banks is beneficial for borrowers.The basic activity of a bank consists in attracting deposits and granting loans. Banks transform the risk of financial contracts, maturity; for example, deposits with a maturity of 6 months, which can be withdrawn at any time, have been transformed by banks into long-term investment loans granted to companies, even with the uncertainty of whether they will be repaid. Banks have added to their core business other ancillary activities, increasingly complex and interconnected.
Norden (2015) sees a bright side and a dark side of relationship lending. The bright side of the relationship between the bank and the borrower is a close relationship that reduces information asymmetry, and the dark side of this relationship is

represented by the retention problems in the interaction between the lender and the borrower. Furthermore, the existing competition between banks is beneficial for borrowers. Berger and Udell (2002) see relationship lending as the most important lending technique for many companies; according to Beck, Demirguc-Kunt and Martinez Peria (2011) it is the key to external fincancing, especially for SMEs.
A close bank-borrower relationship can create benefits for both parties if inefficiencies arising from informational problems are reduced. On the one hand, banks can better assess default risk for existing borrowers, while they may benefit from improved credit conditions over time. On the other hand, banks could follow a cost strategy whereby they offer attractive credit terms at the beginning of a relationship to win over customers, then increase their costs for subsequent financing. Degryse and Ongena (2005) argue that the lending bank can have an informational monopoly over a borrower, since all information related to its activity is in the bank’s possession, which can create a lock-in effect in the event of the termination of a bank-borrower relationship. A more nuanced view was presented by Berger and Udell (2006) and Torre, Martinez Peria, and Schmukler (2010) according to which large and foreign banks, compared to other institutions, may have a comparative advantage in financing SMEs through convenient lending technologies such as asset-based lending, factoring, leasing, credit scoring and centralized organizational structures. While relationship lending might thus be better done by small financial institutions, transaction-based lending is more cost-effectively done by large financial institutions that can exploit the necessary economies of technology investment. In many developing countries, this debate has an additional dimension, as smaller banks are often owned by domestic shareholders, while large financial institutions are often owned by foreigners.
Using data for 91 banks from 45 countries, Beck, Demirguc-Kunt, and Martinez Peria (2011) find that foreign banks are more likely than domestic banks to use transaction-based lending techniques and centralized business models. They also show that foreign and domestic banks lend equally to SMEs. Thus, it appears that both relationship-based and transaction-based lending techniques are appropriate for lending to SMEs. There are also specific transaction-based lending techniques that appear particularly favorable for expanding SMEs’ access to external financing. Leasing is an attractive financing tool for SMEs – from both a demand and supply perspective – as it is based on the cash flow generated by the financed asset, including tax advantages. Factoring, too, is attractive to small suppliers of large creditworthy buyers. Both leasing and factoring are based on a legal framework that regulates transactions. Thus, these techniques can help increase lending to SMEs, even if to a lesser extent.

2.4. SMEs financing offerd by capital market

As we know, small and medium enterprises have a crucial influence on the economic development of every nation, but access to formal financing remains a barrier. Similarly, financial institutions face challenges in assessing the creditworthiness of SMEs for granting financing. Financial institutions use various appraisal models to identify potential borrowers and determine loan pricing and collateral requirements.
As far as the financing offered by the capital market is concerned, this is done either through the issue of bonds or through the issue of shares, an operation that directly impacts the equity (Darovanaia, 2005).

Obligatory loans (financing through the issuance of bonds) are characterized by the medium and long period during which they are issued, they bear interest and do not involve the listing of the issuing company on the capital market.
Most often, SMEs turn to the issue of shares to obtain financing on the capital market. By means of this financing method, SMEs obtain financing without immobilizing assets from the portfolio and without having a high cost of financing. Listing on the capital market implies compliance with certain conditions by the issuer. In the case of applying for a bank loan, SMEs must also meet certain eligibility conditions.
The financing of SMEs through the capital market requires specific knowledge of the functioning of the capital market (Sechel & Nichita, 2010).
The developed capital market facilitates access to financing, both for private and state entities (Sechel I. C., 2012). This is its most important role in the economy: to facilitate the transfer of capital from entities holding capital to those seeking capital (Sechel I. C., 2012). The capital market also offers newly established SMEs the opportunity to obtain credit, unlike the banking system, where, without a financial history, they do not meet the eligibility criteria for obtaining bank loans.
Through the issue of shares, SMEs benefit from non-reimbursable capital, compared to the issue of bonds or contracting a bank loan. However, practically, the issue and sale of shares represents the alienation of a part of the company to third parties. SMEs can use the capital obtained from the issue of shares according to current needs, without respecting certain conditions of use, as in the case of bank loans. The issue of shares, not bearing interest, as in the case of bank financing or the issue of bonds represents a net advantage, an attraction of resources without subsequent costs. The issue of shares involves certain initial costs, but subsequently the company's cash-flow is not burdened by interest payments.
If a company needs capital for a certain project and does not want to list on the stock exchange, it has the option of issuing bonds. Market conditions must also be taken into account in the issue of bonds, so that investors consider them favorable and be a source of profit for them as well. For example, if the coupon level is below the interest rate in the banking system, these bonds will not be attractive to potential investors.
In the situation of issuing bonds, SMEs turn to specialized companies that offer consultancy in the field of the capital market and that can offer them the best solutions. One of the advantages of bond issuing is the possibility for the issuer to "customize" its way of financing, while through the banking system it is much more rigid, SMEs having to adapt to the products offered by the bank.
SMEs that are looking for long-term financing and whose goal is long-term development usually opt for the listing of their own shares on the capital market to the detriment of the issue of bonds. Companies choose this method of financing for several reasons: failure to meet the eligibility criteria imposed by banks; lower financing costs compared to those offered by the banking system; lack of limitations regarding the requested capital; increased visibility of the company in the business environment; the lack of guarantees requested by the banks or even for the sale of some share packages by the shareholders who want to leave the company.

3. SMEs in Romania - bank financing vs. capital market - advantages and disadvantages

In recent years, there has been an increase in the interest of Romanian SMEs in obtaining financing from the capital market, but despite this, the level is low compared to other countries, with the banking system holding supremacy. This is not true for commercial companies in the United States of America, where a considerable percentage of companies are financed on the capital market.

In order for the capital market to become an option for SMEs that want financing, support from the state is also necessary through the implementation of fiscal policies that stimulate stock market activity and increase its degree of attractiveness by popularizing successful examples of companies that opted for financing on the capital market.

Due to the presence of foreign actors in the Romanian economy, both in the banking area and the stock market, the financial market has adapted to international standards. The development of the economy was supported by the development of the two components of the financial area, the banking market and the capital market. Initially, the banking market experienced a more accelerated development at the expense of the capital market. Probably due to lack of experience, fear and mistrust, some of the SMEs eligible for listing on the stock exchange did not consider this method of financing, limiting themselves to obtaining financing through banking entities. A key element that led to the change of this perception was the development of the capital market in Romania, as well as the visible success of the companies listed on the Bucharest Stock Exchange.

From the perspective of financing, most SMEs accept the conditions imposed by banks. Of course, there are also cases of SMEs with good financial conditions and a long history of collaboration with the bank, which have the possibility of negotiating credit terms. As in the case of financing through the capital market, SMEs must meet a series of criteria that lead to the calculation of the scoring of the respective company and on the basis of which the crediting criteria can be established. SMEs are perceived by financial institutions to be less organized in terms of financial data management compared to large corporations, which makes credit risk assessment based on inadequate financial data raise questions for financial institutions. Most of the existing scoring models are based on financial data.

Generally, in Romania, from the category of SMEs, micro-enterprises and small enterprises opt for classical financing through the banking system, while medium-sized enterprises also consider the option of listing on the stock exchange.

A real advantage of the banking system is represented by short-term loans and the relatively short time in which banks provide companies with the necessary capital, in the case of credit lines and loans for short-term current needs. This type of lending cannot take place through the capital market, especially due to the longer period of issuing bonds or listing on the stock exchange.

Another difference between financing through the banking system and that through the capital market consists in the interest rate fluctuation on the banking market, this being influenced by the monetary policies at the level of the economy compared to the capital market, where in the case of bond issuance a fixed coupon rate is offered. Two situations can be encountered: if the fixed rate of the coupon is more advantageous than the variable interest on bank loans, if it registers an increase between the moment of granting and the moment of maturity. However,

the opposite situation is also possible, in which the variable interest rate on bank loans decreases compared to the fixed rate of the coupon. In this context, companies have the opportunity to contract a bank loan at a more advantageous cost through which they can redeem the issued bonds in advance.
Currently, SMEs in Romania can be financed on the capital market either by listing on the main or secondary market (depending on the criteria that must be met), or by issuing bonds. Financing through the capital market offers both opportunities and risks. Every SME that wants to access financing through the stock exchange must do a thorough analysis of both the advantages offered and the disadvantages.
In Romania, we still encounter a reluctance of companies to call on the capital market. Among the identified fears, one can name the following: directly affecting the company in case of financial crises, the reduced desire of companies participating in the capital market regarding the transparency of financial results, the fear of losing control of the companies, and even the increase in the level of bureaucracy in relation to the financial authorities and the investors. That is why many SMEs in Romania still prefer financing through the banking system. Even the companies listed on the stock exchange and which obtain their financing through the capital market, also turn to bank financing in parallel.

Table 1: Differences between direct financing through the capital market and financing through the banking system through a SWOT analysis

	Financing through the capital market	*Financing through the banking system*
Strengths	*The possibility of personalized financing according to needs* *Transparency of companies participating in the capital market* *Low financing costs*	*The main financing option for SMEs in Romania* *The financing is granted for a short period and in relatively short time* *The stability of the banking system, which leads to a high confidence of SMEs* *Extended territorial coverage* *Continuous training of employees and adaptability to new realities*
Weaknesses	*The reluctance of companies to finance themselves on the capital market generated by the lack of trust* *High level of bureaucracy* *The need for qualified personnel in the relationship with investors and the authorities*	*The rigidity of financing criteria, especially for micro-enterprises and small enterprises* *Request for guarantees* *Restrictive financing conditions for start-up companies*
Opportunities	*Identifying the multitude of financing solutions* *Start-up companies can be financed* *The opportunity to interact with*	*Financing SMEs by offering them customized products* *The import of technology and knowledge from the parent banks*

	various national and international companies	*Accelerated digitalization of the banking system*
Threats	*The quick reaction of the stock market to external factors, leading to the fluctuation of the company's value* *The risk of losing control of the company*	*Interest rate increases determined by external factors (financial crises, war)* *Failure to meet customers' needs and expectations*

Source: Own adaptation based on data provided by the Bucharest Stock Exchange and the National Bank of Romania

4. Conclusions

Supporting the development of SMEs, the engine of the economy, must be done by facilitating access to both bank financing and by supporting them in the financing process through the capital market by ensuring appropriate fiscal measures and a stable legislative framework. In some developed economies, the banking system no longer holds supremacy in lending activity. In Romania, we still encounter a reluctance of SMEs to apply for financing through the capital market, probably due to mistrust, fear, lack of experience. In order to change this perception, successful examples of SMEs financed on the capital market should be publicized.

Financing through the capital market as well as through the banking system offers both opportunities and risks, so a SWOT analysis can be done by any SME that needs financing and meets the criteria for both bank financing and direct financing on the capital market for choosing the best option according to needs. Thus, we consider that there is no correct or incorrect decision regarding the choice of one of the two financing methods, but rather it depends on the opportunities that SMEs consider to be more favorable at the time. Any option chosen must be supported, the final goal being stronger and more sustainable SMEs, which will lead to economic growth and implicitly a better standard of living.

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