COLLATERAL'S IMPORTANCE IN SMES FINANCING: WHAT IS THE BANKS' RESPONSE? SOME EVIDENCE FOR ROMANIA

Bădulescu Daniel
University of Oradea Faculty of Economic Sciences

Petria Nicolae
"Lucian Blaga" University of Sibiu Faculty of Economic Sciences

Searching for funding, SMEs' managers face various obstacles arising from information asymmetry, lack of experience, severe market conditions, and insufficient or unsatisfactory collaterals for banks (OECD 2006; Badulescu and Badulescu 2010; OECD 2000 and 2004; Lin and Sun 2006; Toivanen and Cresy, 2000). The collateral issue is extensively discussed in literature – preventing moral hazard, the alignment the interests (Stiglitz and Weiss 1981:393-410; Chan and Thakor 1987:345-363; Jiménez and Saurina 2004), a means to discipline the borrowers behaviour (ex post) given the existence of a credible threat (Aghion and Bolton 1992:473-494), or even banking behaviour on the market (Manove et al. 2001:726-744, Argentiero 2009). In the same time we find that the perception of firms, revealed by National Bank of Romania (NBR 2010) survey data, show that banks still use the collateral as a measure of pressure, in special in crisis times. For an important part of managers, the bank increased the level of required collateral for existing, renewing or new credits, asking for new covenants, revealing a paradox of crisis time: while the bank loans remained the favourite method of external financing needs of business, the banks often reduce their availability. Although the bank loan remains the favorite mean to support the growth ambitions, the higher level of collateral or lending costs are seen as principal obstacles by the majority of manager in EU. According to NBR survey, the influence of risk factors related to collateral had a climax at the end of 2008 and 2009, when the banks have tightened the requirement for loan guarantee. Using National Bank of Romania (NBR 2010) survey data, we show that the banks still use the collateral as a measure of pressure, in special in crisis times. For an important part of managers, the bank increased the level of required collateral for existing, renewing or new credits, asking for new covenants, revealing a paradox of crisis time: while the bank loans remained the favorite method of external financing needs of business, the banks often reduce their availability. According to NBR survey, the influence of risk factors related to collateral had a boom at the end of 2008 and 2009, when the banks have tightened the requirement for loan guarantee. Following the European trend in straightening the credit conditions, Romanian market had a more pregnant evolution with a rapid deterioration of these conditions during the second and the third quarter of 2008. In general terms, the seeking for higher percentage of coverage with real estate collaterals, paradoxically, makes banks more vulnerable, given their pro-cyclical behaviour, feeding the real estate market crisis.

Key words: SMEs lending, collateral, credit standards

JEL code: G21

Introduction

This paper aims to emphasize the importance of collateral in credit risk management, how collateral influences market behaviour of banks and customers selection, but also the excessive focus on collateral coverage during crises times. In the first part, we will review the main theoretical approaches regarding the collateral and its importance for the credit risk management. In the second part we will emphasize the importance that SMEs give to the relationship with financing institutions, and the expectations and obstacles in credit use as important mean for growth. We will detail Romanian experience starting from NBR surveys, and we show that banks' response to crisis in 2009-2010 was to restrain lending, to tighten credit requirements (collateral, costs and covenants) and to enhance caution to real estate market. Finally, we conclude on the banks' behaviour and responses and on the consequences of this attitude on the economy.

1.Overview on the banks' policy regarding collaterals required from SMEs

Focusing on value creation and based on accepted and controlled risks (OECD 2006; Pathrose 2005, banks are often reluctant to grant loans to SMEs. This fact is due to some reasons, such as:

-informational asymmetry, resulting from the lack of standardized financial information and statements provided by SMEs, adding the bank's limited knowledge about the company seeking a loan (Badulescu and Badulescu 2010);

-higher risks associated with SMEs lending, due to limited assets that can be used as collateral, low capitalization and vulnerability to market risks;

-besides the fact that small enterprise cannot provide adequate collaterals, they hardly convince the banks about their managerial and marketing abilities or technical skills, that are essential to generate adequate cash flows and a proper debt service.

On a first sight, the financing provided to SMEs – various, in small amounts and in a reduce typology compared to large companies – could involve lower cost of transactions; however, the situation is, in fact, different. The costs involved by the analysis of the application and disbursement of a loan are generally independent of the requested amount and usually comprises other fixed costs as legal taxes, costs to obtain risk information from specialized agency etc. (OECD 2006). In the case of small amounts, it is very difficult to recover a total cost, and the unique solution could be a strict control of them by standardizing the credit types, reducing the processing time etc. Implementing a scoring system can be a way to consistently reduce and uniform the transaction cost, but this step involves an important database for calibrating, major changes in borrower and lender mentality, and it shows real efficiency only for credit institutions with lots of loan application from SMEs.

Collateral impact on credit risk, and, in a macroeconomic perspective, on the supply of credit to the companies, in special for SMEs, is a topic attracting a constant and increasing concern in recent years. From the theoretical point of view, we find two alternative interpretations that lead, empirically, to different predictions. On the one hand, is the adverse selection problem faced by a bank in financing activity, and therefore, the security offered by debtors can help alleviate this problem (Stiglitz and Weiss 1981:393-410; Chan and Thakor 1987:345-363). Thus, low-risk borrowers are willing to offer a better guarantee, considering their lower risk as a signal for their capabilities fulfil its obligations under the credit agreement and, therefore, are less probability to lose the guarantee. The guarantee is interpreted as a signal that allows the bank to reduce or eliminate the adverse selection problem caused by the existence of informational asymmetries between the bank and borrower, when the loan was approved, (Jiménez and Saurina 2004).

On the other hand, is the opinion, that even there is a *ex ante* symmetry between debtor and creditor (for example, the bank knows the quality of the debtor and correctly predicts the role of loan), guarantees are designed to mitigate the moral hazard problem once the loan was granted. In this respect, the security engaged helps to align the interests of both, creditors and debtors, thereby avoiding a situation where the borrower makes less effort to ensure the success of the project for which funding was granted. Security becomes a means to discipline the borrowers' behaviour (*ex post*) given the existence of a credible threat (Aghion and Bolton 1992:473-494).

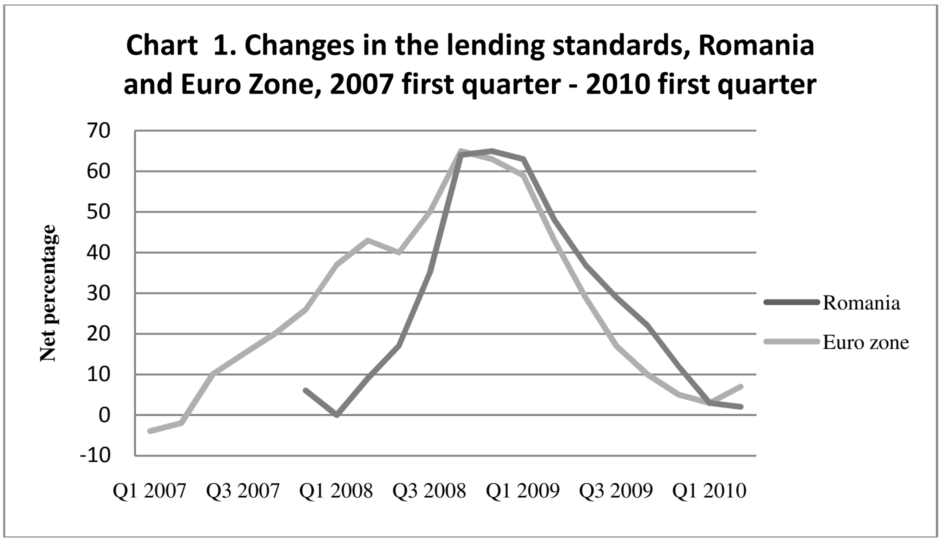
Starting from this view, we can expect to find a direct relationship between loan quality and/or the borrower, and the size of collateral, i.e. the assumption that the guarantee is a signal of high quality borrowers. However, this hypothesis is not agreed by the bankers, who tend to establish a direct relation between the level of credit risk and the volume of collateral.

2.Banks versus customers on SMEs financing. Evidence from Romania

For Romania, the analysis can be completed with another perspective, on the other part involved - the central and commercial banks, and we notice a pattern similar to the EU's one, but sometimes adapted to the specific conditions of the Romanian economy and its response to the crisis. According to the NBR quarterly survey on lending for non financial sector and population (NBR, 2010), lending standards have remained mainly unchanged over the first part of 2010. The degree of accumulated restrictiveness seems to be deemed sufficient in the current economic context, based on the fact that 2009 was characterized by a relatively continuous process of tightening of these standards (see note, NBR, February and August 2010).

According to these researches, the companies associated risks increased throughout the economy, particularly in the construction and real estate sectors and, as confirmed by above data at EU level, corporations have shown, for the first time in Romania last decade, a significant growth risks.

At the aggregate level, lending standards (internal lending norms guiding the credit policy of the credit institutions) were slightly tightened in the fourth quarter of 2009, but remained relatively unchanged in the first half of 2010. The recent developments and projections for the next period, shows that the degree of restrictiveness of credit standards seem to be sufficient in terms of risk aversion of banks in the current economic conditions. It notes, however, that neither the euro area cycle tightening of credit standards is not completed, the level of restrictiveness increased in the first quarter of 2010 (NBR, February and August 2010)



Sources: National Bank of Romania, Bank lending survey, February and August 2010, http://bnr.ro/Studies-3215.aspx şi European Central Bank, The Euro Area Bank Lending Survey - April 2010, http://www.ecb.int/stats/pdf/blssurvey_201004.pdf?0bd480f0b472e26541e56c7c1a5f4dff

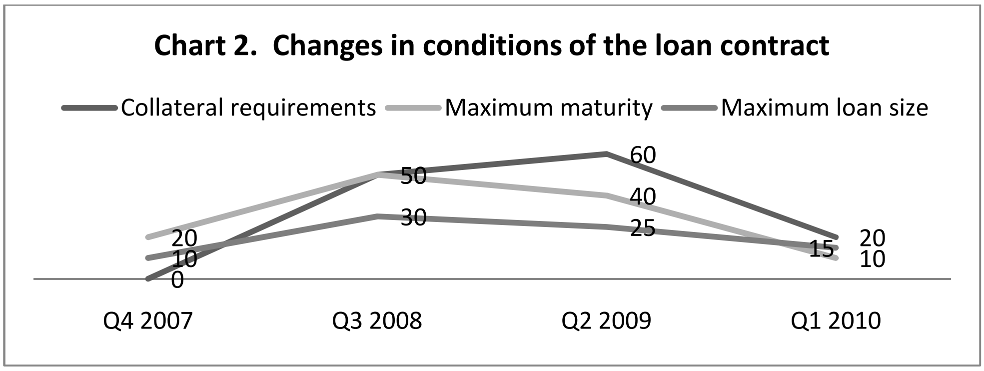
In structure, slight tightening of lending standards of banks in Romania doesn't concern the company size (SMEs. Vs. Corporations), but rather the criterion of maturity. However, the perception of risk to SMEs remains higher than corporate, explaining the reduce availability of bank loans for SMEs. Among the main factors which led banks to change lending standards (as the economic prospective, the risk associated with the industries) were the increasing share of nonperforming loans in the portfolio, the risk of required collateral / security (see Table 1).

Table 1. The influence of risk factors related to collateral, by type of companies (net percentage)

Companies (loans)-period	Companies Total (%)	Large companies		SMEs	
		Short term loans (%)	Long term loans (%)	Short term loans (%)	Long term loans (%)
Q4 2007	20	50	60	40	40
Q3 2008	40	90	90	50	70
Q2 2009	80	60	50	60	60
Q1 2010	20	30	30	10	10

Source: National Bank of Romania, Bank lending survey, February and August 2010, http://bnr.ro/Studies-3215.aspx

Regarding the changes in lending terms and conditions (the specific obligations agreed between creditor and debtor in the credit agreement signed, i.e. interest rate, collateral, maturity, etc..), we notice a clear tightening in the second quarter of 2010, at the same pace as in previous quarters. Terms under review were mostly those related to collateral, given that over 75% of non-financial credit is collateralized. Frequently, banks alternate between increasing the costs or decreasimg the maximum available loan.
According to reporting banks, the LTV (loan to value ratio, i.e. maximum share of credit in the amount of real estate collateral) for loans on the balance at the middle of 2010, secured solely by mortgages, stands at 87%. In the case of new loans granted in first part of 2010, banks had a more cautious attitude, the same indicator was 76 percent (NBR , February and August 2010).



Source: National Bank of Romania, Bank lending survey, February and August 2010

Conclusions

As conclusion, we can notice that banks still try to avoid moral hazard in the relationship with borrowers – i.e. SMEs, as that moral hazard can increase in crisis period. Banks have only secondary interest in the informational asymmetry issue. We also have found that the tightening of non-price conditions (i.e. collateral) has been used as a recovery practice in order to cover the macroeconomic or specific sectors risks increasing the size of collateral, often unrelated to individual performance of the companies. Moreover, increased propensity for real estate collateral, accompanied now by more pessimistic assessment of market value (see LTV development, specified above) seems to indicate an emphasis on limited perspective, only seeking for extended credit risk coverage, but ignoring the emergence of a new risk, the risk of collateral. It seems that the link between the bank propensity for fixed collateral and cyclicity of real estate market (see Kim, Y.-J., Lee, J.-W 1999, FDIC, 1998) is not yet seen by the banks as a valid threat. The supervisory authorities' efforts to mitigate this pro-cyclical behaviour haven't got the desired effect.

Note: 1. Interpretation and presentation of answers was based on the *net percentage,* given the difference between the share of banks that reported tightening standards, terms and conditions of lending, and the percentage of banks reported easing of these, a positive short term balance indicates that a larger roportion of banks have tightened lending standards (NBR , February and August 2010).

References:

1.Aghion, Philippe and Bolton, Patrick. "An Incomplete Contracts Approach to Financial Contracting." *Review of Economic Studies* (1992): 473-494.

2.Argentiero, Amedeo.*" Some New Evidence on the Role of Collateral: Lazy Banks or Diligent Banks?"* Institute for Studies and Economic Analyses, Rome, (2009). Accesed: 15-01-2011: http://fileserver.carloalberto.org/id2009/argentiero.pdf.

3.Badulescu, Daniel and Badulescu Alina. "Financial Constraints Facing SMEs: Some Theory and Evidence.", *Metalurgia International* vol. XV (2010), Special Issue no. 8

4.Berggren Bjorn, Olofsson Christer and Silver Lars."Control Aversion and the Search for External Financing in Swedish SMEs", *Small Business Economics,* Volume15, (2000)

5.Chan, Yuk-Shee and Thakor, Anjan V. "Collateral and Competitive Equilibria with Moral Hazard and Private Information".Journal of Finance, American Finance Association,(1987), 345-363.

6.Cressy, Robert and Olofsson Christer. "European SME Financing: An Overview", *Small Business Economics*, Volume 9, (1997)

7.European Central Bank, *Survey on the Access to finance of small and medium-sized enterprises in the euro area: second half of 2009*. Accessed: 07.01.2011: http://www.ecb.europa.eu/pub/pdf/other/accesstofinancesmallmediumsizedenterprises201002en.pdf.

8.FDIC's Division of Research and Statistics: History of the Eighties — Lessons for the Future , Volume I, Chapter 3, 1998. Available at: http://www.fdic.gov/bank/historical/history/137_165.pdf. Accessed: 07-01-2011

9.Jiménez Gabriel and Saurina Jesus. „Collateral, Type of Lender and Relationship Banking as Determinants of Credit Risk". *Documento de Trabajo no 0414*. Banco de Espana, Madrid, (2004).

10.Lin, J. Y., Sun, X.: *Information, Informal Finance, and SME Financing*, Springer-Verlag, 2006

11.Kim, Y.-J., Lee, J.-W.: *Overinvestment, Collateral Lending, and Economic Crisis*, Center for International Development at Harvard University, Working Paper No. 4, 1999

12.Manove, M, Padilla, A. J. and Pagano Marco."Collateral versus Project Screening: A Model of Lazy Banks". *RAND Journal of Economics*, The RAND Corporation, 32(4), (2004). 726-744,

13.National Bank of Romania, *Bank lending survey, February and August 2010*, Available at: http://bnr.ro/Studies-3215.aspx, Accessed: 16.01.2011

14.OECD: *Financing newly emerging private enterprise in transition economies*, 2000

15.OECD: *Promoting entrepreneurship and innovative SMEs in a global economy: Towards a more responsible and inclusive globalization*, 2004

16.OECD *The SME Financing Gap, Volume I Theory and Evidence*, 2006

17.OECD: *Policy Briefs*. Available at: www.SourceOECD.org. Accessed: 20-05-2010

18.Pathrose, P. P.: *Banks must re-invent SME financing*, Accessed 26-05-2010 http://www.thehindubusinessline.com/2005/,

19.Stiglitz, Joseph and Weiss, Andrew. *"Credit Rationing in Markets with Imperfect Information". The American Economic Review*, Vol. 71, No. 3. (1981), 393-410. Accessed: 16-01-2011: http://mcb.unlp.googlepages.com/StiglitzWeiss1981.pdf..

20.Toivanen, Otto and Cressy, Robert. *"Lazy Entrepreneurs or Dominant Banks? An Empirical Analysis of the Market for SME Loans in the UK",* (2000), Accessed: 16-01-2011, http://www.staff.city.ac.uk/~cressy/LAZYEntrepreneurs.pdf

21.National Bank of Romania, *Bank lending survey, February and August 2010*, Available at: http://bnr.ro/Studies-3215.aspx, Accessed: 16.01.2011