ARE SMES MORE CONFORTABLE WITH SMALL DOMESTIC LENDERS? (I – THE LITERATURE)

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Small and medium enterprises (SMEs) are recognized having an important role in economic development, but this recognition doesn't resolve the essential problems of the SME sector. We found that one of these are the problems of insufficient or inadequate funding, the lack of availability of financial institutions or private equity investors to meet the SMEs financing requirements. The need for financing of SMEs is predominantly covered by bank loans, but it is difficult to say if this demand finds an appropriate offer, in amount and structure. Thus, it is important to understand if the role of lending techniques and organizational structures of the banks, types and origin of the owners (state, private, domestic or foreign) or the size and the market power (large, small, local, or niche banks) individualizes the banks offer and if the banks know the best way to mitigate the demand and supply constraint. Even though the traditional view explains the strategic predisposition of large banks to finance their clients(by default large clients, corporations) through transactional lending and, and local/domestic banks use the relationship lending- suitable to small customers (SMEs), however, the more recent opinions show that the large international banks use a combination of methods and techniques to gain favorable position on SMEs segments.

Keywords: SMEs lending, large banks, foreign banks
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Introduction

There is an evidence that small and medium enterprises (SMEs) have an important role in economic development of any country, demonstrated by the large number of practical and theoretical approaches, however, this unanimous recognition doesn't resolve the essential problems of the SME sector, among them are the problems of insufficient or inadequate funding, the lack of availability of financial institutions or private equity investors to meet the SMEs financing requirements.

The objective of this work consists in the understanding how SMEs are affected and how they perceive the bank involvement in financing SMEs needs, in terms of the nature and characteristics of organizational structure of these lenders. Based on an generous literature, we quickly review the issues of supply and demand constraints in SMEs financing, the favorite place of bank loan financing the SME needs, and then we have focused on the nature and particularity of lenders that may affect the quantity and adequacy of funds lent to SMEs: the role of lending techniques and organizational structures of the banks, types and origin of the owners (state, private, domestic or foreign) or the size and the market power (large, small, local, or niche banks). The main findings we have corroborated and tested with our recent research results, where we have investigated the SMEs perception about the link between specificity and nature of lenders and their involvement in SMEs lending. We considered necessary to update the main finding from literature and our research with the recent events and decisions took by the large international European banks, regarding their presence and involvements in the Central and Eastern European market, including Romania.

The overall study is organized as follows: I. Introduction, II. The importance of the bank finance and the main difficulties of SMEs lending, III. Bank features and SMEs lending, IV. Our research. Methodology, data and content and assumptions, V. Discussion and results, VI. Conclusion. The present paper focuses on chapters I-III.

1.The importance of the bank finance and the main difficulties of SMEs lending

Based on Flash Euro barometer Access to finance No 271/2009 (European Central Bank and European Commission 2009), 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*). 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%), in the construction sector, or that have introduced innovation in at least one area – products or services, marketing, production and management (18% vs. 14% in non-innovative companies). According to the same survey, 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 used a bank loan. Other alternative to financing were: public source (10% of respondents), a friend or family member (as named "other loans" with 7%) and a very few managers (1%) said they had used a subordinated loan, participation loan or similar financing structures.

Other financing forms as leasing, factoring 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 and European Commission 2009).

Where are the place of bank loan in the future, what expectations have the SMEs managers from banks, and what are the anticipated obstacles accessing bank finance? Around 59% from SMEs managers considered that their SMEs would be able to obtain the desired result after talking to banks about financing, and around 27% are skeptics. It was noted that confidence to talk about future financing with banks was the highest in Slovenia (93%), Belgium, Slovakia or the Czech Republic (between 85% and 90%). Romania - together with Lithuania, Croatia and Estonia - shows a moderate confidence (between 56% and 69%). Overall on UE, the confidence to talk about future financing with banks was highest among managers of companies with at least 10 employees, that had combined internal and external financing in the past six months (65%), or that reported growth in turnover in the past three years (64%-65%), or had seen their financial situation improve in the past six months (72%), (European Central Bank and European Commission 2009).

Bank loans were also the most preferred type of financing for future needs: 64% of managers who expected their company to grow in the coming years answered that they would prefer to apply for a bank loan to realize this growth. Regarding the countries rank, we notice that the loans option is dominant in Malta (86%), Finland (79%) and Luxemburg (78%) and register the lowest position in Latvia (36%) and Estonia (29%). Romania has rather a skeptic position (49%), under European average of 64%.

The Euro barometer offers interesting information regarding perceived obstacles for future development of their business related to bank loan. For example 27% from SMEs managers who would prefer a loan from a bank considers that there would be no obstacles while a similar proportion (26%), however, thought that insufficient collateral (or guarantee) would be the main limiting factor to stop them receiving the required financing, and 24% mentioned interest rates and a price that would be seen as being "too high". Countries situation is more interesting, on the first places is Germany, where SMEs managers saw the importance of loan barriers no more than 47% of options, and on the last place is Romania, where all kind of obstacles cumulate 92% of answers! For Romanian SMEs managers the most frequent obstacles are: high interest rates and a price (46%) and insufficient collateral (European Central Bank and European Commission 2009). However, dominant opinion in each country was that the willingness of banks to provide financing would remain the same. Furthermore, in all countries surveyed, not more than a fifth of managers expected that access to bank loans would improve in the next six months. With all this imperative need for financing and the clear identification of banks as favorite lenders, the banks are reluctant to lend to SMEs. The scholars (OECD 2000, Cressy and Olofsson 1997) often divide the reasons of unsatisfactory financing in two large categories: the demand and the supply constraints of SMEs financing, including the following:

-the information asymmetry that arises from small businesses' lack of financial information, the bank's limited knowledge about the borrower company (Badulescu and Badulescu 2010), lack of relevant financial and commercial track records. The second issue is the moral hazard: once the loan granted, the control of its use according to the original application (the risk and opportunity analysis) could face serious difficulties, the loan could be used for other purpose.

-high failure rates, low capitalization and vulnerability to market risks. The limited power in market, considerable share of intangible assets, insufficient circulating assets or tangible fixed assets tends to create a higher risk profile of SMEs for potential investors (OECD 2004, Lin and Sun 2006, Toivanen and Cresy 2000, OECD 2000).

-Insufficient collaterals to meet 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 banks are unable to determine whether the borrower possesses the technical, managerial and marketing skills to generate adequate cash flows and service the loan

-in developing countries, the risk profile is supplementary marked by the unstable legislative and competitive environment, with negative consequences on the transactions security.

The problems of inadequate funding of SMEs may come also from the supply (*supply side constraints*), and in particular to the way in which financial institutions work (Beck et. al. 2010):

-overlapping between the state institutions and banks (private or not) regarding the SME financing, distorting the market mechanisms and influencing competition;

-excessive collateral requirements could result from conservative methods in the assets valuation and risk weighting (Badulescu 2010, RAM Consultancy Services 2005);

-Insufficient ability of loan officers to understand and analyze the SME sector, seen as less attractive because "the banks would occur substantial amount of cost to process the loan, while the absolute dollar returns are much smaller compared to large corporate loan. Applying the same techniques of large corporate evaluation to SME obviously results in many SME not being able to meet bank lending criteria" (RAM Consultancy Services 2005);

-complicated procedures, expensive and sometimes unnecessary (detailed business plans, documentation and risk scenarios, commitments in legal forms) together with long credit approval period but shorter repayment period for the loans. Finally, the overall costs (financial and time) to obtain a credit can be substantial, and deter SME from banking financing;

-structural problems – unclear definition of SME, insufficient financing alternatives to bank loans, lack of comprehensive and easy to use SME databases, fragmented banking systems (RAM Consultancy Services 2005).

2.Bank features and SMEs lending

While SMEs consider bank financing very important for their development, is important to understand what are the most important bank features, which optimize the bank-SME relation. In other word, what are the better type of bank for SME lending, analyzing ownership, dimension, structure, the origin of owner, technique and internal organization use in lending process, etc.

The analysis of SME financing, various theoretical studies or empirical evidence provides a considerable quantity of information regarding relation between structures of the financial institution, technologies, management. Moreover, recent researches (Berger and 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 (Berger and Udell 1996, 2004).

According to Berger and Udell, ”transactions lending technologies are primarily based on “hard” quantitative data that may be observed and verified at about the time of the credit origination” (Berger and Udell 2004). This kind of information comes, *ex limited*, from the financial indicators calculated on the basis of financial statements; information provided by credit bureaus, the national database of payments incidents – as cheques, promissory notes, the Central Credit Registers, collateral registration, valuation reports etc. The main feature of this type of information: are relatively easy to observe and checked and can serve as a basis for future decisions. Standardized and disseminated through internal channels of communication inside the financial institution, are used for conceptualizing and standardization of the credit policies, in line with corporate strategies, being a reliable element in the management of the networks of the large international banks.

On the other hand, the relationship lending “is based significantly on “soft” qualitative information gathered through contact over time with the SME and often with its owner and members of the local community […] may include the character and reliability of the SME’s owner based on direct contact over time by the institution’s loan officer” (Berger and Udell 2004). To these are added the information stored in the records of the credit institution (frequency of transactions, payment behavior, the number of additional operations carried out by the shareholder or manager in own name - deposits, credit cards) or from variables, intuitive interactions with employees, clients or the suppliers, or with other entities. Unlike transactional lending, authors insist on the fact that, more often, credit officer is the holder of such information, proprietary in nature, and these information can be hardly standardized and sent through official channels within financial institution, difficult to be verified by other experts, located in head offices, separate by the customer interaction

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 and Naaborg 2005, Berger and Udell 2004). This assumption can be explained by following reasons:

-Foreign-owned institutions are part of large organizations, have advantages in transactions lending to some SMEs due to 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

-Foreign bank has often difficulties in processing and transmitting soft information inside their network, with various managerial layers. But the advantage of a great expertise and experience with multiple and different economic, cultural, language, and regulatory conditions, could easy transforms into a weakness point. Often SMEs acting on local markets are little impressed by the cosmopolite image of the large banks.

-Domestic banks are more suitable to finance SMEs because they are better engage 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

A recent paper (Beck et all. 2010), shows 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, and the share of secured SME loans is lower among domestic banks than foreign banks, these foreign banks n banks use different lending techniques and organizational structures to reach out to SMEs. (Beck et al. 2010)

Regarding the ownership (state vs. private) we noticed that state-owned banks may have comparative advantages in transactions lending comparing with privately-owned institutions, but these cannot always transform in an advantage.

Referring on scale economies, and the differences between large banks compared with small, niche banks we can say that the large bank could take advantage from hard information processing, but are disadvantaged in processing soft information because there are difficulties to quantify and transmit this kind of data through 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 and Udell 2002).

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, and Udell 2003):

-Large bank institutions are found to lend to larger, older, more financially secure SMEs, they based their SME credit decisions more on strong financial ratios than on relationships

-Large banks often promote lower interest rates and obtain lower yields on SME loan contracts comparing with small institution, which have to compensate the higher costs with flexibility, non-bureaucratic procedures in credit assessment (Berger, Rosen, and Udell 2003, Berger 2004)

-Small banks have more longer, privileged and personal relationships with their SME customers, comparing with larger banks, based on long distance, impersonal and short terms relation with customers, appreciated as weaker (Petersen and Rajan 1997, Stein 2002) and often unsatisfactory for a better loan decision.

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, the researchers find no evidence that foreign banks tend to lend less to SMEs than other banks, i.e. that different bank types, applying different lending technologies and organizational structures can play an important role in financing SMEs, in developing economies.

Conclusions

The present paper has sought to put into question, theoretically and then, practically, how different types of financial institution could influence the availability for SME lending. We started from the E.C and E.C.B researches and surveys amongst SMEs, which showed that the issue of financing is of prime importance for SME and banking lending is, and will be, the preferred way by SMEs in order to fulfill their objectives. It was mentioned the main opinion of the literature relating to the manner in which various kinds of banks build the lending relationship with SMEs, being underlined two approaches: transactional lending and relational lending. We have identified the main guidelines and characteristics of the lenders in relation with borrowers. Foreign banks and large (private) banks are focused mainly on transactional lending (“hard” data, scorings, national databases, internal channels, decision and risk centers, certain types of collaterals etc.) and this approach seems more appropriate for the large firms. On the other hand, there are small, niche banks, local, domestic, that offsetting the effectiveness of the large banks techniques by a greater proximity to the client, processing "soft" data, recover the close relationship with the customer, asking fewer or various collaterals, but their small power cannot support the whole need for funding of the SMEs sector. We found recent opinions who stated that large banks use both transactional and relational lending, and SMEs are not an exclusive area of domestic/niche banks.

The theoretical conclusions, far from being unanimous, show, however, a few directions: although the large banks build their expanding policies (territorial, market share, profitability, technological) on behalf of large clients, are also interested by the SMEs sector. Foreign banks have not proved, at least until the onset of the crisis, as acting pro-cyclic for their subsidiaries countries; on the contrary, these banks have increased their involvement in economies, including the SMEs sectors. Finally, as we stated in other paper, we consider that a well-balanced structure of banking sector, a real knowledge of SME needs, a relationship banking based on mutual trust can exploit all opportunities, creating a large base for meeting SME financing requirements.

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