Katarína Belanová

"FINANCIAL GAP" IN SMALL AND MEDIUM-SIZED ENTERPRISE FINANCE

Abstract: *Small and medium-sized enterprises (SMEs) are the backbone of all economies, as well as a key source of economic growth, dynamism and flexibility in advanced industrialised countries, emerging and developing economies. SMEs constitute the dominant form of business organisation, accounting for over 95% and up to 99% of enterprises depending on the country. They are responsible for between 60 – 70 % net job creation in OECD countries. Small businesses are particularly important for bringing innovative products or techniques to the market. Financing is necessary to help them set up and expand their operations, develop new products, and invest in new staff or production facilities. Due to the fact that a substantial portion of the SME sector neither has sufficient collateral required for collateral based lending, nor high enough returns to justify the risks taken by venture capitalists, these enterprises cannot obtain finance from the formal financial system, which leads to the SME financial gap. The paper deals with the reasons of the SME financial gap, its differences among the countries, discusses if it is possible to measure them and provides the proposals how to overcome it.*

Keywords: *financial gap, SME, collateral based lending, venture capital*

JEL : G 32

Introduction

SMEs[1] are vital for economic growth and development in both industrialised and developing countries, by playing a key role in creating new jobs.

[1] On 6 May 2003 the Commission adopted Recommendation 2003/361/EC regarding the SME definition which replaced Recommendation 96/280/EC as of 1 January 2005. The revision takes account of the economic developments since 1996 and the lessons drawn from the application of the definition. In particular, it raises the financial ceilings to take into account price and productivity increases since 1996 and introduces a typology of enterprises (difference between the three categories: autonomous, partner and linked) and a calculation method for the thresholds, which gives a realistic picture of their economic strength. It ensures that enterprises which are part of a larger grouping and could therefore benefit from a stronger economic backing than genuine SMEs, do not benefit from SME support schemes.

Enterprises qualify as micro, small and medium-sized enterprises (SMEs) if they fulfil the criteria laid down in the Recommendation. In addition to the staff headcount ceiling, an enterprise qualifies as an SME if it meets either the turnover ceiling or the balance sheet ceiling, but not necessarily both.

Many small businesses start out as an idea from one or two people, who invest their own money and probably turn to family and friends for financial help in return for a share in the business. But if they are successful, there comes a time for all developing SMEs when they need new investment to expand or innovate further. That is where they often run into problems, because they find it much harder than larger businesses to obtain financing.

Generally spoken, there are a number of distinctive recurring approaches to SME finance, but they can be summarised by two main approaches [2].
These are:
I. *Collateral based lending* is offered by traditional banks and finance companies, made up of a combination of the following:
1. Asset-based finance.
2. Contribution based finance.
3. Factoring based finance, using reliable debtors or contracts.

II. *Information based lending covering:*
1. Financial statement lending.
2. Credit scoring.
3. Relationship lending.

1 Viability Based Finance Offered by Venture Capital

A substantial portion of the SME sector does not have sufficient collateral required for the collateral based lending or high enough returns to justify the risks taken by venture capitalists. In addition, many markets have little or unreliable information, limiting the effectiveness of financial statement lending and credit scoring. This has led to the *SME financial gap*, meaning that there are significant numbers of SMEs that could use funds productively if they were available, but cannot obtain finance from the formal financial system.

This ”financial gap“ is all the more important in a fast-changing knowledge-based economy because of the speed of innovation. Innovative SMEs with high growth potential, many of them in high-technology sectors, have played a pivotal role in raising productivity and maintaining competitiveness in recent years. But innovative products and services, however great their potential, need investment to flourish. If SMEs cannot find the financing they need, brilliant ideas may fall by the wayside, and this represents a loss in potential growth for the economy. (For example, the “bagless” conceptions: The “bagless” vacuum cleaner and the “wind-up” radio or flashlight which need no batteries are now common household items, but nearly failed to see the light of day because their inventors could not find financial backing to transform their ideas into production).

The other danger is that these SMEs will abandon the formal system altogether and operate in the informal economy, sidestepping taxes and regulations, and thus not making a full contribution to economic growth and job creation.

The aim of the paper is to show the reasons of the SME financial gap, the differences among the countries, if it is possible to measure it and to provide the proposals how to overcome it.

2 Reasons of the SME Financial Gap

The difficulties that SMEs encounter when trying to access financing can be due to an incomplete range of financial products and services, regulatory rigidities or gaps in the legal framework, lack of information on both the bank's and the SME's side. Banks may avoid providing financing to certain types of SMEs, in particular, start-ups and very young firms that typically lack sufficient collateral, or firms whose activities offer the possibilities of high returns but at a substantial risk of loss.
SMEs tend by their very nature to show a far more volatile pattern of growth and earnings, with greater fluctuations, than larger companies. Their survival rate is lower than for larger companies. Thus, SMEs are at a particularly severe disadvantage when trying to obtain financing relative to larger and more established firms. It can also be difficult for potential creditors or investors to distinguish the financial situation of the company from that of its owners. The entrepreneur may have re-mortgaged his or her house to acquire the start-up funds for the company, for example. If there are two cars in the driveway, can one or both be considered part of the company's assets? If the owner dies, is there someone to take over the business, or will it die with him or her?

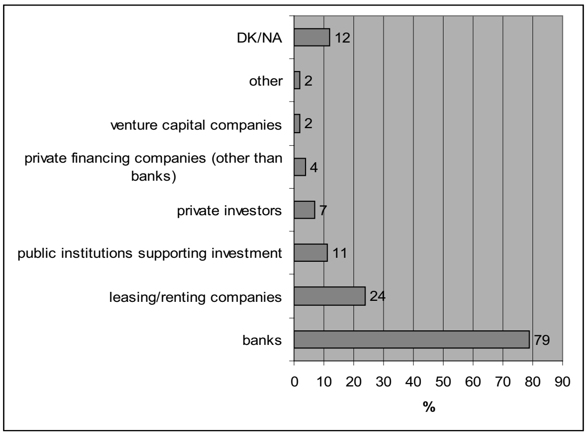
The SME may have several stakeholders, but again unlike a large company, they are likely to be the friends and family of the SME owner. What happens if one of them decides to take his or her money elsewhere – will the other stakeholders make good on the investment, will they look for a new investor in their own circle, or will they ask the bank for more money?

This is a very different set of financial circumstances than that faced by banks when dealing with large well-established firms, so the whole risk assessment is different. Banks and other traditional sources of credit may decide that SMEs represent a greater risk than larger companies, and respond by charging higher interest rates. This makes it more difficult for SMEs to borrow than for bigger companies, and may make it effectively impossible for many SMEs to borrow money at all because the price of credit is too high.

On the other hand, in most countries, commercial banks are the main source of finance for SMEs (Figure 1), so if the SME sector is to flourish it must have access to bank credit.

Figure 1

Sources of financing for EU- based SMEs



Note: DK/NA – Do not know/not answered
Source: [3]

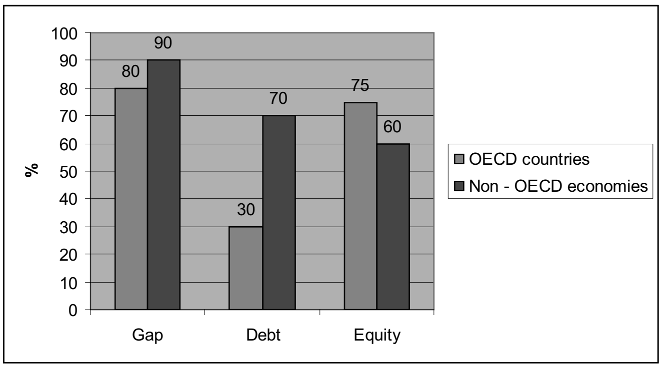
3 Differences according to Countries

The empirical evidence whether a "SME Financial Gap" exists in reality is rather mixed depending on a region.

While the SME financial gap is more pervasive in emerging markets, business financing overall is not a problem in OECD countries (Figure 2), where banks are adopting strategies to cope with reducing the risk of lending to SMEs, and where there are well-established systems for raising money through banks and capital markets.

Figure 2

SME financial gap in OECD and non-OECD economies



Note: In many cases of debt in OECD countries, this problem is limited to a sub-set of SMEs, mostly start-ups and very young firms. Data is based on the responses of 20 OECD and 10 non-OECD economies.
Source: [4]

Many countries that do not report an overall financial gap for SMEs say that they do have a financing problem when it comes to innovative SMEs, precisely because they do not fit the mould applied in traditional SME financing. Since innovative SMEs tend to be newcomers to the market, or seeking financing for a new type of product or service, and usually have negative cash flows and untried business models, they represent a higher risk to banks and cannot be assessed in the same manner as traditional SMEs or large firms.

The overall SME financial gap is particularly pressing in non-OECD countries, since the bulk of them report a widespread shortage of financing for all categories of SMEs. Even though SMEs account for a large share of enterprises, and represent potential employment and economic growth in emerging economies, they receive a very low share of credit. Indeed, most of them are denied any access to formal financial markets.

The characteristics of the banking system in emerging markets[2] frequently inhibit SME lending. Many banks are state-owned, their credit may be allocated on the basis of government guarantees or in line with government targeting to develop specific sectors. Often banks are subject to ceilings on the interest rates they can charge, which makes it difficult to price credit in a way that reflects the risk of lending to SMEs. Many banks may have ownership and other ties to industrial interests and will tend to favour affiliated companies. In a market where banks can earn acceptable returns on other lending, it will not develop the skills needed to deal with SMEs.

Market-based banking, where banks are accountable for achieving high returns to shareholders and maintaining high prudential standards, is gaining acceptance on a global level. This model creates a competitive market where there is more incentive for banks to lend to SMEs, but many emerging markets have been comparatively slow in implementing this model.

Several studies have been performed, looking at financial development and access to finance in Eastern Europe, and more specifically on the possibility of an "SME Financial Gap" in that region.

[5], [6 and [7] all find the indication that leverage in Eastern Europe is low and the access to external finance is insufficient, either in terms of the associated cost or the availability. All studies attribute this problem to some sort of institutional factors.

More evidence for a "SME financial gap" has been presented by [8]. In this study the authors state that banks in transition countries are more reluctant to provide debt-financing to SMEs than in developed countries. Another explanation for the lower debt-levels in Eastern Europe compared to Western Europe has been presented by [9]. In her study of nine Eastern European countries, she points out that domestic credit provided by the banking sector compared to GDP, is around 40 percent in the observed region of Eastern Europe, and more than 100 percent in Western Europe.

As OECD countries have competitive financial markets, SMEs do not generally have a problem in obtaining bank loans since banks perceive SME finance as

[2] See http://en.wikipedia.org/wiki/Emerging_markets to find out which countries belong among the "emerging countries".

an attractive line of business and are developing, or have developed, effective techniques to deal with them. They replace their traditional risk assessment models with new techniques to distinguish high- and low-risk SME borrowers, and to identify those likely to expand and survive. Banks are also altering the nature of their products, with an increasing proportion of their revenue coming from fees for services rather than interest on loans, which favours lending to entities such as SMEs.

Nonetheless, OECD governments are convinced that there are still enough instances of market failure in SME finance to justify focused government intervention. Countries have launched a number of programmes to use public funds to facilitate SME lending, and the available official surveys suggest that banks' efforts to develop the SME market, supported in some cases by a moderate amount of government guarantees, have resulted in a situation where a large share of SMEs have access to bank financing.

Differences are emerging between countries also in terms of how easy it is for innovative SMEs to grow and develop. This sector has been very dynamic in the United States and a few other countries, but has lagged in many continental European countries and Japan, to the detriment of job creation and competitiveness.

Despite the importance of innovative SMEs, they face particular problems when attempting to access financing in most OECD countries, as they represent a higher risk than traditional SMEs or large firms. They are thus not really candidates for "traditional" bank loans. Moreover, banks are mindful of the fallout from the burst of the "dot.com" bubble after the steep rise of Internet-related start-ups in the late 1990s.

Instead, innovative SMEs rely on investors who will provide risk capital, generally in return for a share in the company. The risks for the investor are high, but so are the potential rewards if he or she is backing a winner.

Financing for innovative SMEs is complicated by the fact that these firms are likely to require a range of financing vehicles at different stages of their development. The "seed" money to start up the company generally comes from friends, professional contacts and family. The SME may also be able to tap into government funds, structural funds or university grants for developing prototypes or carrying out feasibility studies. Increasingly, "business angels" are seen as a vital link in the financing chain at the early stage of business development, as they bring business experience to the table as well as their own capital.

As SMEs begin to grow, but have yet to establish the track record or size and collateral that would give them access to bank financing, they tend to turn to other types of risk capital offered by venture capitalists, who favour larger projects at later stages of the business cycle. Funds are usually obtained from institutional investors, especially pension funds, but financial intermediaries and the corporate sector are also major investors.

Although there are many countries (including some in the OECD) where the venture capital industry is still under-developed, the global venture capital industry is now a relatively mature industry that has succeeded in mobilising hundreds of billions of dollars from institutional investors and deploying these funds to attractive business opportunities throughout the world.

In contrast to the formal venture capital sector, the role played by early stage risk capital, although not well known, is more relevant for innovative SMEs, and thus represents an opportunity for government policy intervention.

Governments can play an important role in supporting the SME sector, particularly where there is market failure, or where incomplete markets inhibit the provision of adequate financing on terms suitable for the SME's stage of development.

4 Size of the SME Financial Gap

One fundamental problem in dealing with the SME financial gap is lack of basic information about just how big such a gap may be. Often the only evidence is in the form of complaints from SMEs themselves, and this is difficult to use in analysis or for comparison. Moreover, the definition of an SME varies between countries and financial institutions (see definition for the EU SMEs in the introduction); some only compile figures by size of loan, not by size of the company borrowing, and some do not keep regular statistics of SME lending at all. And this is just in OECD countries – outside the OECD area, information is even scarcer.

However, the size of the (formal) SME Financial gap was estimated by IFC and McKinsey&Co. Table 1 shows the results in billions of US Dollars:

Table 1

Size of the (formal) SME financial gap

REGION	Formal SME Credit	Formal credit gap	Increase needed
LatAm	$180-200	$160-190	70-100%
East Asia	$2000-2500	$250-300	11-13%
SS-Africa	$25-30	$110-130	400-480%
OECD	$11500-13000	$600-700	4-6%
MENA	$80-100	$150-200	170-210%

Note: The figures above only take formal lines of credit into account and neglect informal financing needs. Informal financing needs is the segment where most starting and young businesses find themselves in. So for reality sake the figures may be almost twice those stated above.
Note: SS Africa – Sub-Saharan Africa
MENA – Middle East and North Africa
Source: [11]

Table 1 also shows how regions like East Asia seem to be well financed; however, the disparities between countries are very large.

These results make clear that banks, financial institutions, investors need to take hold of the opportunity before them. Starting with domestic banks, funds and investors.

5 How to Bridge the SME Financial Gap?

Government measures to promote SMEs should be carefully focused, aimed at making markets work efficiently and at providing incentives for the private sector to assume an active role in SME finance. Where necessary, banking systems should be reformed in line with market-based principles.

Governments should also act to improve awareness among entrepreneurs of the range of financing options available to them from officials, private investors and banks. Micro-credit and micro-finance schemes play an important role in developing countries and efforts should be made to boost their effectiveness and diffusion.

Any provision of official funding should respect the principle of risk sharing, so official funds should only be committed in partnership with funds from entrepreneurs, banks, businesses or universities. Governments should also look at whether government technical support can be used generate the emergence of business angels and to make the existing business angel systems operate more efficiently.

Policy makers need to ensure that the tax system does not inadvertently place SMEs at a disadvantage. They should also review the legal, tax and regulatory framework to ensure that it encourages the development of venture capital.

At the same time, national policies should encourage diverse forms of institutional savings and institutional investors should be regulated flexibly.

The market for corporate control, esp. SMEs should be allowed to function efficiently for both domestic and foreign entities.

In order to assess the success of such actions, governments need to be able to measure the size of the SME financing gap and evaluate the impact of government actions.

Summary

The economic and social importance of the SME sector is well recognized in academic and policy literature. It is also acknowledged that these actors in the economy may be under-served, especially in terms of finance.

An issue that has a possible impact on the capital-structure of SMEs is the so-called "SME Financial Gap". In a survey performed by the "OECD SME Task Force", most OECD member countries agreed that a lack of appropriate financing does have a negative impact on the growth of innovative SMEs. The "SME Financial Gap" is commonly defined as the situation where a significant share of SMEs cannot fulfil the financing needs which exceed their internal financing capacities, through banks, capital markets or other suppliers of finance. There are different reasons why the financial constraint of SMEs is larger than that of large companies. One reason is that the problem of asymmetric information is more severe in SMEs (OECD 2006). This is partly due to the fact that in many cases the company is very much tied to the entrepreneur. This leads to a situation where the entrepreneur has considerably superior information on the situation of the company. Related to this is also the problem that a manager in an SME is more likely to have insufficient management skills compared to the managers in large companies. Therefore potential investors have a more difficult time to assess whether a SME manager is making bad management decisions which could potentially threaten the well-being of the company. Morale hazard considerations also play a significant role for the availability of credit to SMEs. The lending bank is mainly interested in a firm's capability to repay its loan, while the company might prefer a high risk and high return strategy, which could lead to risk shifting Even though risk shifting is a potential problem with any kind of debt financing, it is usually more severe when lending to SMEs because, as mentioned, the asymmetric information present when dealing with SMEs is higher compared to large listed firms.

If entrepreneurs cannot gain access to finance through the regular system, they may not start up a business or simply go out of business, a potential loss to the economy. But the other danger is that they will abandon the formal system altogether and operate in the informal economy, sidestepping taxes and regulations, and thus not making a full contribution to economic growth and job creation.

There have been at least two distinctive approaches to try to overcome the so-called SME financial gap.

The first has been to broaden the collateral based approach by encouraging bank lenders to finance SMEs with insufficient collateral. This might be done through an external party providing the collateral or guarantees required. Unfortunately, such schemes are counter to basic free market principles, and they tend to be unsustainable.

Thus, the second approach has been to broaden the viability based approach. Since the viability based approach is concerned with the business itself, the aim has been to provide better general business development assistance to reduce risk and increase returns. This often entails a detailed review and assistance with the business plan.

Literature

[1] www. oecd.org
[2] en.wikipedia.org/wiki/SME_finance
[3] EOS Gallup Europe (2005), "SME Access to Finance", Flash Eurobarometer 174, October.
[4] OECD SME and Entrepreneurship Financing Survey, 2006.
[5] CORNELLI, F. – PORTES, R. – SCHAFFER, M.: Capital Structure – Specifics *in Emerging European Economies, Scholarly Paper*, 2010.
[6] CHAVES R. – SANCHEZ S. – SCHOR S. – TESLIUC E.: Financial Markets, Credit Constraints, and Investment in Rural Romania. *World Bank Technical Paper* No. 499, 2001.

[7] EGERER, R.: Capital markets, financial intermediaries, and corporate governance: An empirical assessment of the top ten voucher funds in the Czech Republic, Washington: WB, 1995.
[8] BRATKOWSKI, A. – GROSFELD, I. – ROSTOWSKI, J.: Investment and finance in de novo private firms: Empirical results from the Czech Republic, Hungary and Poland. Warsaw: Center for Social and Economic Research, 1998.
[9] JOEVEER, K.: „What do We Know about the Capital Structure of Small Firms?," *CERGE-EI Working Papers wp283*, The Center for Economic Research and Graduate Education - Economic Institute, Prague, 2005.
[10] EOS Gallup Europe 2006.
[11] International Finance Corporation and McKinsey&Co, August 2010.