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The Debate about Financing Constraints of SMEs in Europe

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Small and medium-size enterprises (SMEs) are highly dependent on bank financing, which is why they have been particularly hit by tighter credit conditions in the aftermath of the global financial crisis. Given that SMEs account for about 60% of value added and 70% of employment in the euro area, they are crucial for economic recovery. Consequently, several policy initiatives have been launched to alleviate SMEs' financing constraints. This Roundup gives an overview of the current debate about financing obstacles of SMEs in Europe and collects policy recommendations from the economic literature.

In 2014, several years after the financial crisis began, more than 10% of SMEs in the euro area still reported financing constraints as their most pressing problem (ECB 2014). Not only has new bank credit to SMEs in the euro area declined by 35% between 2008 and 2013 (Economist 2014), but lending rate spreads between loans for small and large firms have also significantly increased (OECD 2014, Kaya 2014). This development is problematic because SMEs use external funds to finance new investment, inventory, and working capital (ECB 2014).

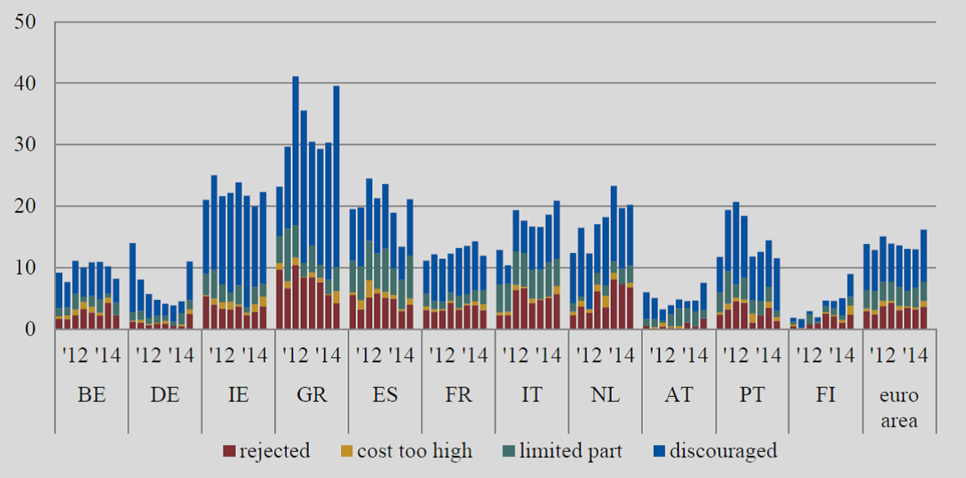
Even if SMEs in Europe still face financing obstacles, their situation varies widely across countries. As illustrated in Figure 1, SMEs in countries with the worst recessions, like Greece, Ireland, Spain, and Italy, struggle most. In these countries, small firm loan applications are rejected more frequently, lending costs are higher, and more enterprises are discouraged from applying for a loan than the euro area average. Thus, in the peripheral countries where SMEs play a particularly important role for economic prosperity, financing obstacles are the greatest. In contrast, German SMEs were barely affected by the crisis and have fully recovered since (EC 2013a). Financing constraints appear not to be an urgent problem for German SMEs.

Measuring external financing constraints

Economic analyses of firms' financing constraints are either based on surveys or on balance sheet data. Information on the financial conditions of small firms in the euro area is available from the Survey on the Access to Finance of Enterprises in the Euro Area (SAFE). This survey, established in 2009, is conducted twice a year. Measures of perceived and actual financing constraints can be constructed using survey questions on firms' usage of external financing, their loan applications, rejections, and potential discouragement to apply for a loan (Ferrando and Mulier 2013). As an alternative way of gauging the severity of financing obstacles, many studies use balance sheet information to evaluate firms' sensitivity of investment with respect to their cash-flow, following Fazzari and Petersen (1993). The idea behind this measure is that financially constrained firms adjust investment in response to changes in cash-flow more than less constrained ones, because the former must rely more on internal funds. As the cash-flow sensitivity of investment is criticized by several researchers, like Kaplan and Zingales (1997), Almeida et al. (2004) suggest measuring financial constraints as the cash-flow sensitivity of cash. According to this measure, firms keep accumulating funds out of their cash flow because they are unable to receive external financing.

Figure 1: Obstacles to receiving a bank loan for SMEs across euro area countries

(over the preceding six months; percentage of respondents)



Base: SMEs for which bank loans (including subsided bank loans) are relevant. Figures refer to rounds four (October 2010-March 2011) to 11 (April-September 2014) of the survey.
Note: Financing obstacles are defined here as the total of the percentages of SMEs reporting loan applications which were rejected, loan applications for which only a limited amount was granted, and loan applications which were rejected by the SME because the borrowing costs were too high, as well as of SMEs which did not apply for a loan for fear of rejection (i.e. discouraged borrowers). The calculation of the indicator starts in 2010 when the question on applications for bank overdrafts was included in the questionnaire.
The components of the financing obstacles indicator are affected by the amendments to the questionnaire in round 11 (i.e. filtering based on the relevance of the financing instrument and addition of the new category "My application is still pending"), and past data have been revised accordingly. The figures are calculated including the new category "My application is still pending" and "Do not know". See Annex 4 for more information on the changes introduced in the questionnaire and their potential impact on the indicator.

Source: ECB (2014), Report on the Survey on the Access to Finance of Enterprises in the Euro Area, April - September 2014, November, Chart 18.

Which firms are most constrained?

Small and young firms typically face greater external financing obstacles than larger and older ones because of their opaqueness. As SMEs are mostly not publicly listed, hard information about their profitability and financial situation is not available to potential lenders. Due to this information asymmetry, SMEs do not have many alternatives to bank financing: they strongly rely on banks that gather soft information through, for example, a long-term relationship (e.g. Beck et al. 2014). Access to funds from capital markets is much more difficult and, thus, rare.

Which firm characteristics matter for the access to finance of SMEs? Using the SAFE-data, Artola and Genre (2011) confirm that especially small and young SMEs have faced credit constraints during the crisis. In a similar vein, Ferrando and Mulier (2013) show that less productive, more leveraged, and younger SMEs have been more likely to experience financing obstacles. Concentrating on perceived financing constraints, Ferrando and Griesshaber (2011) find that in addition to firm age, ownership structure is an important determinant of access to finance. SMEs that are owned by shareholders or by other firms are shown to be less financing constrained.

Need for action?

Among market participants and observers, there is no consensus of whether the observed financing constraints reflect fundamental weaknesses like low profitability or weak capitalization of SMEs, especially in the periphery countries, or if they are instead a symptom of ongoing stress and restructuring in the banking sector (Kaya 2014). In the debate over policy interventions to support SMEs, short-term measures that address the recovery from the recent financial crisis must be distinguished from structural measures focusing on long-term dynamics in the SME sector.

Short-term, crisis-related measures

Even if Holten et al. (2011) stress that the increase in the cost of borrowing for SMEs can be explained to a considerable extent by the weak macroeconomic developments and increased borrower risk, a lack of bank credit supply also played an important role for financing constraints (Popov and Udell 2012). During the global financial crisis, the weak capital positions, liquidity problems, and low profitability of banks have impaired their lending capacity. According to Wehinger (2014), SMEs were the hardest hit by the adverse credit market conditions. The author argues that policy interventions to support lending to SMEs have offset at least part of the reduction in credit availability. For example, at the national level, many European countries provided credit guarantees, export facilitation, and direct credit to SMEs. Bergthaler et al. (2015) point out that national support for SMEs has also been implemented through postponement of tax or social security payments for those SMEs in financial difficulties. At the European level, among others, as an anti-crisis measure the European Investment Bank increased its SME supporting measures by 50% between 2008 and 2011 (EIB 2011).

Apart from measures directly targeting SMEs, liquidity provisions by the ECB, including LTROs and TLTROs, have aimed at supporting the credit market and to incentivize banks to extend more credit to the non-financial sector. Yet, Kaya (2014) argues that liquidity measures to support the liability side of banks' balance sheets only had a limited impact on SMEs borrowing costs. Using Portuguese loan-level data, Iyer et al. (2014) also find only limited positive effects of liquidity support on credit supply due to a liquidity hoarding of banks.

Long-term prospects

When thinking about structural factors, what should be done to improve SMEs' funding situation?

Using firm-level data for the 1989-2006 period, Baum et al. (2011) show that an economy's *financial architecture* matters for small firms' access to finance in normal times. Their results suggest that, in normal times, bank-based systems tend to reduce financing constraints of SMEs better than capital market-based systems. Yet, the authors concede that in times of banking system stress, SMEs face greater financing obstacles in bank-based than in market-based systems. Beck et al. (2014) find that *banks' lending techniques* matter for credit constraints. Relationship lending reduces financing constraints of SMEs in cyclical downturns but not in booms. Hence, according to this study, a banking system with banks that use soft information alleviates financing constraints of SMEs in bad times.

Bergthaler et al. (2015) stress that policy interventions should focus on supporting viable but distressed SMEs, while exiting nonviable SMEs. They suggest that the *resolution of SME problem loans* should be facilitated with incentives for restructuring SMEs debt such that the banks' capacity to extend loans to viable SMEs increases. Moreover, SME financial reporting and disclosure must be improved in order to increase *transparency*. In a similar vein, Kay et al. (2014) argue that the financial information on SMEs should be standardized through, for example, centralized credit rating agencies. As an additional means to ameliorate the credit availability for SMEs, the authors suggest boosting the financial market knowledge of small firms and to offer training in the preparation of loan applications.

Another set of studies point out that as young firms are mostly small, small firms are often wrongly perceived as the engine of growth. Yet, empirical results reveal that *young firms* are most important for employment, investment, and growth (Haltiwanger et al. 2010, Lawless 2013). A recent empirical analysis by Banerjee (2014) reveals that external financing constraints particularly mitigate the profitability of start-ups, so that policy measures should aim at facilitating access to finance especially for young firms. The author argues that improving record keeping of firm credit histories or establishing mini-bond markets for SMEs could be an effective way to spur growth. An example for a recently established alternative funding market is The Alternative Fixed-Income Market (MARF) in Spain. As the requirements to use MARF are more flexible than officially regulated fixed-income markets, MARF allows smaller enterprises that are typically not listed to issue bonds in a cheaper, quicker, and easier way.

Closely related to this argument is the current discussion about the establishment of a Capital Markets Union in Europe. One important goal of the European Commission (EC) in this respect is to promote *alternative funding sources* for SMEs and start-ups in order to relax the close connection between the banking sector and the economic performance of SMEs (EC 2015). One way to improve access to finance for small and young firms put forward by the EC is to strengthen European venture capital and equity markets, which play a much smaller role in financing of European SMEs compared to the United States. Moreover, according to the EC, a revitalization of the SME *securitization* market could provide about 20 billion euros of funding. In a similar vein, Kaya (2014) argues that fostering the securitization of SME loans may be an effective way to channel funds to the real economy.

Conclusion

Given that it is difficult to clearly separate credit supply from credit demand factors, there is so far no consensus to what extent the observed financing constraints of European SMEs are driven by credit rationing or fundamentals. Still, due to the important role that young and small firms play for innovation and employment, many observers are in favor of policy initiatives that improve the access to finance of SMEs. Yet, in order to know which measures are most effective in this respect, further research is needed.

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