COLLATERAL IN SMES' LENDING: BANKS' REQUIREMENTS VS CUSTOMERS' EXPECTATIONS

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Abstract:
SMEs' support and importance in developing economies should not be only declarative. Searching for funding, managers encounter 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 behavior (ex post) given the existence of a credible threat (Aghion and Bolton 1992:473-494), or even banking behavior on the market (Manove et al. 2001:726-744, Argentiero 2009). In the same time we find that the perception of firms, revealed by European Central Bank (ECB 2009, 2010), shows 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 favorite 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. Furthermore, the seeking for higher percentage of coverage with real estate collaterals, paradoxically, makes banks more vulnerable, given their pro-cyclical behavior, feeding the real estate market crisis, as the theory of collateral as a signal of banking behavior "lazy banks vs. diligent banks", gains a new understanding.

Keywords: SMEs lending, collateral, credit standards

JEL Classification: G21

INTRODUCTION

Small and medium-sized enterprises (SMEs) are engines of growth in developing economies; the role and the future of SMEs tend to be a major concern of economic policy, given their strategic importance in reshaping the productive sectors, in employment and innovation. We have to recognize, however, that the fulfillment of these objectives is not simple, and one of the biggest problems facing SMEs is the lack of adequate funding, the reluctance of financial institutions or private capital regarding the finance requirements of SMEs.

This paper aims to emphasize the importance of collateral in credit risk management, how collateral influences market behavior of banks and customers selection, but also the excessive focus on collateral coverage during crises times. Based on specific studies of European Commission, European Central Bank for EU, and National Bank of Romania for Romania, we will show the major gap between SMEs' managers' expectations concerning the bank loans, on one hand, and the restrictive practice and limited vision of banks, on the other hand, particularly in last three years.

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. On the other hand, we will prove that the negative European SMEs' managers perception regarding the tighten credit requirements is real, and banks hardly succeed (or even they are not interested) in satisfying SMEs needs. Finally, we conclude on the banks' behavior and responses and on the consequences of this attitude on the economy.

FINANCING RESTRICTIONS FACING SMES

Banks, like other businesses, focus on value creation, based on accepted and controlled risks, (OECD 2006; Pathrose 2005). Banks are reluctant to grant loans to SMEs, due to a number of 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). The quantity and quality of information held by the entrepreneur in respect of its business activities can not be accessed in the same measure by the potential creditor. Thus, the creditors, the banks, are unable to make an effective discrimination between good projects, "bankable", and doubtful projects, and in this case, the price (here, for example, loan interest) will not be an efficient selection (discriminate), but rather will lead to a portfolio with many risky loans: some of them with interesting perspective, others - safe failures (the phenomenon of adverse selection). A second problem is moral hazard: once the loan granted, the control of using in accordance with the original application (risk and opportunity assessment) would be facing serious difficulties, and the loan could be used - in whole or in part - for other purposes. To reduce this risk, the creditor will demand security: company assets, receivables, personal assets, land or buildings, or will ask repayment of the loan, or, if possible, will try to restrict the access to the unused rest of the loan;
- higher risks associated with SMEs lending, due to limited assets that can be used as collateral, low capitalization and vulnerability to market risks. Lending institutions consider the environment of SMEs as highly competitive and uncertain (compared with large enterprises), which implies a considerable variability of results for similar SMEs working in the same sector and, finally, a high default rate. Limited market power, the high percentage of intangible assets, lack of relevant records of historical financial results and business, insufficient fixed or current assets, tend to create a higher risk profile of SMEs for potential investors, (OECD 2000 and 2004; Lin and Sun 2006; Toivanen and Cresy 2000). Insufficient collateral for creditors in order to overcome moral hazard risks are, probably, the most often invoked explanation regarding the difficulties accessing a loan. Insufficient collaterals can be also an expression of an early stage of the business, unconsolidated yet, or even an excessive demand for credit, away from the real capacity of the company engaged in the proposed project;
- 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. Often, SMEs are characterized by poor technical equipment, difficulties in ensuring qualified technical staff and an experienced management (human capital in general), to adapt to multiple and rapid changes of today's economic realities. Finally, the accuracy of the reports, insufficient legal business protection are barriers for financial institutions to determine the real profitability of the company, repayment ability, or the strength of guarantees. In developing economies, the risk profile is marked, additional, by unstable legislative environment, with negative consequences on transactions security.

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.

The Credit Bureaus' creation can be a significant step forward in solving these difficulties (OECD 2004), but a consistent number and volume of independent cost remains, as related to: site visits for collaterals reviewing and general survey of the borrower, loan administration cost, etc. For developing countries, the problems are even more extended, due to: insufficient performance of evaluators, lack in IT reports, legal problems in registration of collaterals and enforcement sale of collaterals etc. Finally, an increase in the general level of fees and interests is predictable, but also tempered by competition, acceptance from SMEs etc.

For developing countries, the restrictive factors already mentioned fill out with institutional and legal factors. First, we refer to the features of the banking system, which, if concentrated and uncompetitive, will restrain the expansion of SMEs sectors, both through conservative policy of customer evaluation, and through high rate of interest. All of these represent factors reducing the incentive of the banks to renew the products, to be closer to SMEs sector, to take and assume the risks related to innovative and new economic fields. Furthermore, developing countries have an unconsolidated stock market, so the interest of institutional investors is diminished, they haven't a pragmatic and transparent method to enter and exit from the capital of selected business. At institutional level, we can speak about the rather discordant measures taken by the authorities: guarantee funds, state aid, fiscal facilities, consulting etc. in order to support the SMEs in accessing finance and developing their businesses.

The behavior of lenders invoking informational asymmetry, risk profile related to SMEs or insufficient legislative and organizational framework is only one side of the explanation of the financial gap in the case of SMEs. To support their arguments, banks or other investors, pointed the relative reduce number of "bankable "companies, or reliable to invest in them, so called "the demand side constraints".

From this point of view, often the lenders deal with a considerable number of projects that don't comply to the minimum requirements in order to be taken into consideration for financing. The reason for the rejection of these projects is often controversial, but the dispute between the banker conservatism and the poor quality of presented projects can be solved referring to neutral, good repute institutions: experts, academics, scientists, who often admit that the number of real good, innovating and well sustained (in terms of financing needs and repayment capacity) applications is very short. This is the case both in traditional both in innovative industries: IT, micro-technologies, where the number of puerile, incomprehensible, unsustainable projects is extremely high and the pipeline of valuable and valid project is limited. Before being a competition issue, the poor quality of projects is a problem of perception, and the entrepreneurs should be aware that it matters in the same weight for lenders.

The second restriction consists in the incapacity of the managers to take advantage of all the opportunities occurred in the search for financing sources, regardless of the inner quality of the project proposal. It is about the inability to convince and argue through valuable ideas, about the low availability to allocate sufficient time to build a solid and based on trust and closeness relationship with the credit institution, in order to compensate the lack of other resources, and this issue is valid for all categories of lenders or investors: institutional investors or angels investors. Often, the manager have little patient to cover all mandatory stages, considering it as a waste of time, which unfit him from the attention to the technical aspects of the project. They ignore, voluntarily or not, the financial aspects of the project, foreign trade procedures, encashment risks, insurance, very important for the safety and continuity of their business and well appreciated by investors, too.

The third aspect of demand side restrictions is related to the venture capital financing and express the opposition of the owning manager to give up the control of the business, in favor of outside person, the so call "control aversion", extremely outspread in many countries, no matter the financial market development. Some researches (Cressy and Olofsson 1997; Berggren, Olofsson and Silver 2000) show that the rejection occurrence is more widespread among the companies in early stages of development, when the investor has more self confidence in his personal abilities and the prospective of the business, and it is more temperate at the maturity stage, when the owner intimately knows the reality of the entrepreneur life.

COLLATERAL, CREDIT RISK AND BANK BEHAVIOUR

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.

For other scholars, (Manove et al. 2001:726-744; Argentiero 2009), the size and quality of collateral is linked to the banks behavior on the market. This dichotomy speaks about *lazy banks vs. diligent banks.* "Lazy banks "are defined as those banks that prefer to substitute a careful and efficient screening of projects with a high concern for the size and quality of proposed collaterals. In such framework, safer borrowers offer more guarantees compared with risky borrowers, primarily to give a signal about themselves when they are evaluated by a bank, and secondly, to avoid the implications of carefully credit analyzing and screening, as for risky borrowers. Banks, in turn, will adapt to this process and, gradually, will reduce their analysis and monitoring activities for borrowers with substantial collateral. Therefore, risky but innovative projects tend not to be financed, thereby reducing the social welfare.

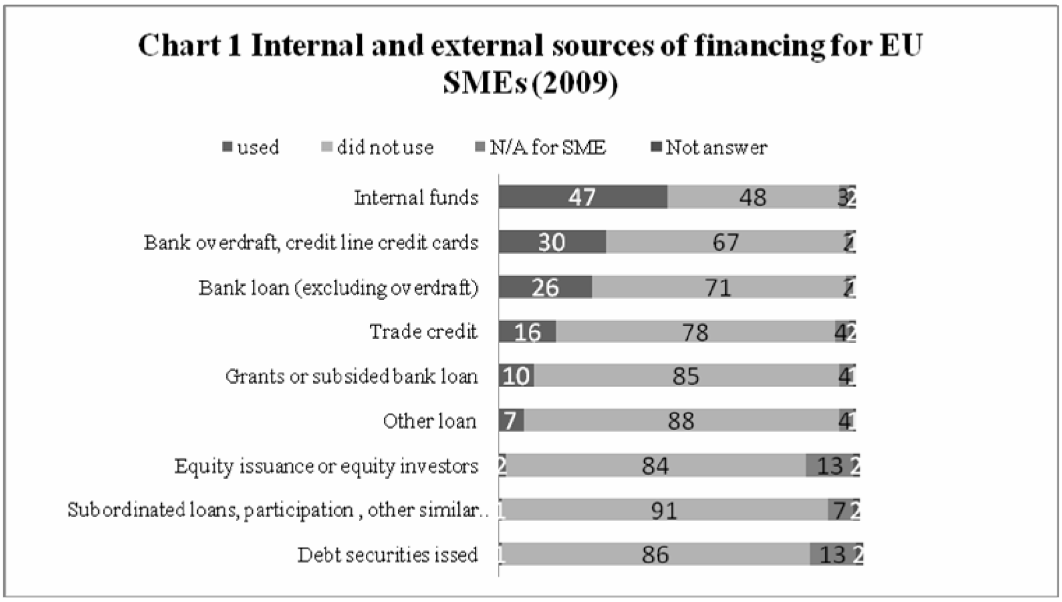
Although interesting, and certainly based on some market behaviors, a model of "*lazy bank vs. diligent bank*" does not seem to be confirmed by statistical data; the results suggest a rather different kind of diligent behavior of these banks (Argentiero 2009). In addition, research has shown that the presence of collateral is not able to reduce credit risk (default risk) *ex post*, these results are consistent with the theory that understands the collateral as a credible commitment against informational asymmetries, and not as convenient coverage against credit risk *ex-post*.

In addition, there are significant differences in banks' policy on the role of collateral required in long-term loans (compared with the short term), because this collateral is a part of a risk, but also it may increase coverage as the borrower made systematic repayments. Finally, we haven't ignore the influence of the regulatory environment, the possibility of applying the law on forced execution of collateral, that may influence the type and size of committed collateral, as the other non-price covenants asked in credit agreements.

BANKS' REQUIREMENTS VS CUSTOMERS' EXPECTATIONS REGARDING SMES FINANCING. THE EU CASE

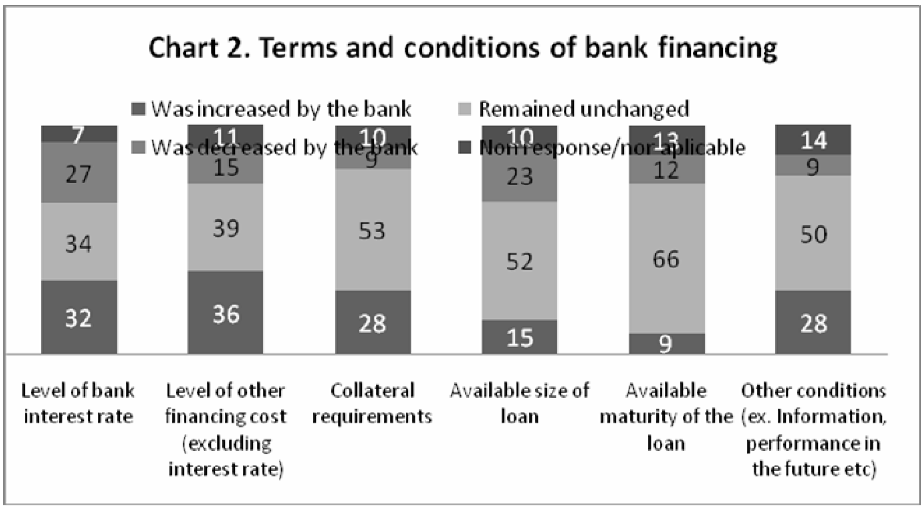
Our analysis aims to reiterate those assertions by comparing two complementary, but suggestive, points of view: some information revealed by the Flash Eurobarometer Access to finance No 271, conducted for the European Commission (Directorate General for Enterprise and Industry) in collaboration with the European Central Bank, a survey on the access to finance of small and medium-sized enterprises in the euro area, and National Bank of Romania quarterly surveys on lending of non financial sector and population (February and August 2010).

Thus, according to the Flash Eurobarometer Access to finance No 271 (ECB, 2009), one of the most important concerns for managers of SMEs in the EU is access to finance, this problem was mentioned by more than 16% of respondents (just following "finding customers", but more important comparing with the" competition" or "availability of qualified staffl"). Regarding sources of funding, almost half (47%) of managers in the EU responded that the company used its own funds in the last six months to finance its operations (some have only used their own funds, while others used a combination of equity to external financing). The most common forms of external financing (resources) were bank loans, about 30% of companies using at least one overdrafts (overdraft) or line of credit, and 26% have taken a traditional bank loan, with fixed maturities, a smaller proportion using public financing, friends or family, or other forms of financing - leasing, factoring or hire-purchase.



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

According to the above mentioned survey, managers of companies that have applied for a bank loan in the last six months were asked to assess changes in the terms and conditions of the bank financing for their company. Approximately one third (32%) of managers said that interest rates were raised by the bank during this period and a somewhat lower proportion (27%) responded that their bank has decreased these rates in the last six months. Similar results to the question of changing interest rates on loans, show the SME managers opinion on changing non-price related terms of funding, about 36% of the respondents said that non-price terms (such as guarantees, loan maturity, size of the bank approved the credit application, etc...) have been increased / strengthened by their bank in the last six months and a smaller proportion (15%) said these costs have declined, while 39% saw no change.



Source: the same as Chart 1

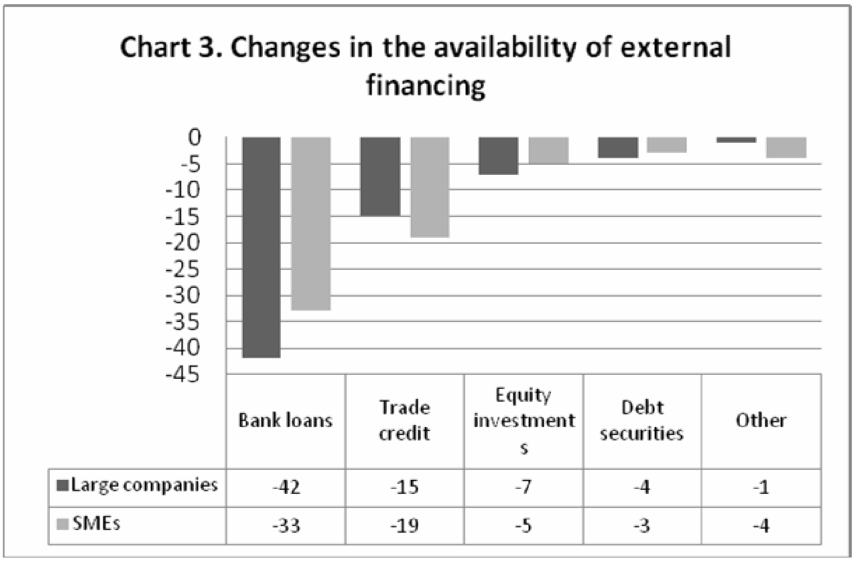
On the other hand, for the majority of managers, the changes imposed by banks in connection with non-price terms and conditions known significant differences, for example, a significant proportion of managers consider that the bank tightened credit agreement , including the size / the quality of the guarantees.

In a general view, grouping the responses în two category of "increased" or "decreased", is more likely to say that the terms and conditions of the financing banks have deteriorated rather than improved. For example, 28% of managers believed that collateral requirements have been increased by their bank in the last six months, while only 9% said they decreased.

Regarding the characteristics of companies affected by these changes in bank loans conditions, it is estimated that large companies with at least 250 employees and / or with an annual turnover of between 10 and 50 million €, which have applied for a bank loan found that collateral requirements or other non-price terms have deteriorated during that period, and the same opinion was recorded from companies with five and nine years on market. Surprisingly, companies with fewer than 10 employees, start-up companies, or less than two years existing on market, did not consider that the bank has increased interest rates or non-price conditions (including collateral), but we consider this neutral to positive response of small businesses and start-up managers is given by the relatively limited access to bank loans of this type of company, and their modest relevance in banks' loan portfolio, covered by collateral.

In terms of sectoral point of view, the majority of managers in construction sector (46%), considered that the terms and conditions of bank financing, required size of collateral, were deteriorated in 2009, compared with only 19% responses from managers of firms working in industry. Also, managers of innovative companies share the pessimism saw in construction sector.

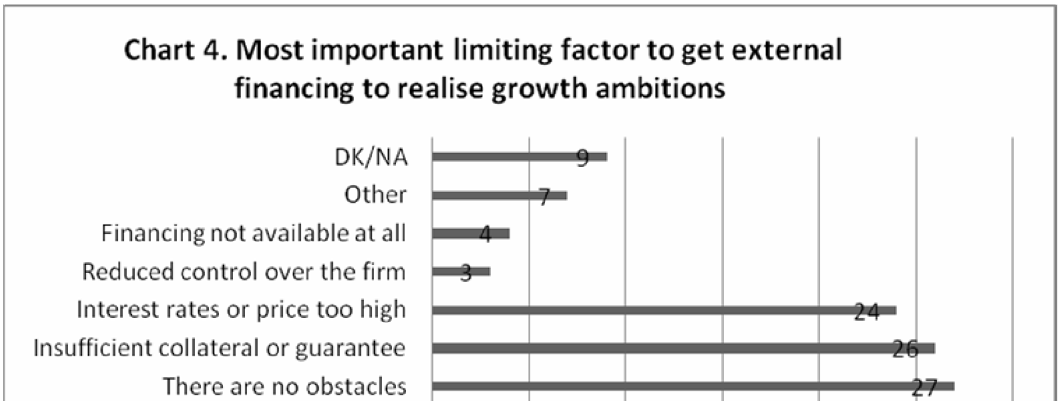
Businesses characterized by stationary or decreasing turnover reported generally tightening of a non-price terms (collateral, commitments, etc.) requested by the bank, and, last but not least, the increase of price conditions. For example, while 42% of company managers showed a deterioration in the situation of their company in the last six months have said that banks have asked for a higher collateral for renewing the existing credit lines, for the managers of companies who experienced an improvement of their financial situation, that percentage is about at half (24%).



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

The trends analyzed above explains, at least in part, the paradox of the bank credit in the current period of crisis: while the bank loans has remained the favorite method of external financing needs of business, he recorded the steepest drop in their availability; more than 40% decreasing for large firms, and about 33% decreasing for SMEs (Chart 3).

According to that above mentioned research, where the SME managers see the bank loan as the preferred form to achieve growth ambitions, however, they believe there are important restriction in using these financing form: first, the insufficient collateral required by lenders; this view grouping about 26% of all responses, second- the cost of financing, with 24%. Significant at lower importance (3-7%) was mentioned other restrictions, such as loss of control over their companies if the bank would grant credit.



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Analyzing variations from one country to another, within the same options for bank credit, we see a significant distance between the views of managers in Germany, which, in a significant proportion (53%) foresee no significant obstacles in achieving growth targets, and Romanian managers, the most pessimistic in this regard - they see all sorts of obstacles - the proportion of over 82%. In this pessimism, Bulgarian and Romanian managers indicate the high cost of bank financing

(58% for Bulgaria or 41% for Romania), but the SMEs managers from Spain and Italy see the insufficient collateral for bank loans as the main obstacle to further development of business (36% and 34%).

From this point of view of collateral, the prospect of SMEs in Romania appears, in a European context, as acceptable, with only 18% versus 26% EU average.

Table 1. Most important limiting factor to get a loan (%)

Country	**There are no obstacles**	**Insufficient collateral or guarantee**	**Financing not available at all**	**Interest rates or price too high**	**Reduced control over the firm**	**Other**	**DK/NA**
Germany	53	26	6	6	0	7	2
Belgium	49	2	4	12	4	9	20
Austria	37	33	1	10	3	7	9
France	37	31	1	7	5	10	8
Netherlands	34	9	3	19	9	12	4
Denmark	31	12	6	12	14	5	20
Portugal	31	13	1	33	11	5	6
United Kingdom	30	15	8	23	11	1	13
Sweden	29	20	19	0	1	11	20
EU27	27	26	3	24	4	7	9
Bulgaria	24	8	2	58	0	4	5
Poland	19	31	5	35	3	2	6
Spain	18	36	2	23	0	7	7
Italy	12	34	3	32	0	2	11
Romania	8	18	8	41	4	12	10

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

CONCLUSIONS

What does emerge from these data and theoretical assertions, about the banks behavior in relation to the required loans collateral? First, we consider the bank behavior still striving to avoid moral hazard in the relationship with borrowers SME for example, as that moral hazard can increase in crisis period. Banks appear to show a secondary interest to the problems of informational asymmetry. However, these surveys have a considerable generalization effect, referring mostly to existing credit relationships, and less to the new loans to new customers, so the banks are, in general, aware about the deterioration of economic data parameters - financial or business, of the company. Secondly, we perceive the tightening of non-price conditions - here, relating to collateral – as a recovery practice of a less "creative" bankers diligence, in order to cover the macroeconomic or specific sectors risks (e.g. construction, new technology, etc.) 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 an 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 behavior haven't got the desired effect. From this perspective, we believe that the named theory "*lazy banks vs. diligent banks*" gain a new understanding and applicability.

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