SOURCES OF FINANCING EUROPEAN SMES AND NEW SUPPORTING EU POLICIES: EVIDENCE FROM THE NEW EU MEMBER STATES

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Abstract:
The SMEs' access to finance is crucial for the creation, survival and growth of these firms. In the light of the recent global crisis, the dramatic fall in demand for goods and services and the reduced availability of bank loans has led to the aggravation of the problems faced by SMEs when they prospect for purchasing financial resources. In this context, our paper aims to highlight the sources of financing used by the European SMEs and the new policies proposed by the European Commission to facilitate their access to finance. The analysis carried out in this paper is based on data and statistics provided mainly by the European Commission and the World Bank. Based on the methodology used, the paper mainly indicates, the major problems regarding the financing opportunities faced by SMEs and the indispensable necessity for the adoption of measures, especially at EU level, to support their access to finance.

Key words: *SMEs, financing, constraints, European Union policies*

JEL classification: *E44, G30, O16*

1. Introduction

In most countries, SMEs produce a significant part of GDP and bring a substantial contribution to job creation. For example, in the case of the EU countries, the SME sector generates about 60% of the value added to the European economy and provides about 67% of the total employment. The crucial importance of the SMEs it is also recognized by the EU framework of reference for SMEs, namely the Small Business Act for Europe, launched on June 2008, which aims to anchor the "Think Small First" principle in law and policy making to strengthen SMEs' competitiveness.

SME financing is a subject of great interest also for the researchers and for policy-makers. The reluctance of some financial institutions and investors in providing financial resources for SMEs, particularly for innovative startups, which are vital for economic and social development of countries, has led to increasing debate regarding difficulties encountered by these firms when aiming to procure financial resources and features of the financing of the SME sector.

Despite the efforts of the policy-makers in various countries, including at European and international level, to improve financing of SMEs, analyzing the empirical studies and various research reports we found that the access to finance for SMEs is one of the most important barrier to the creation, survival and development of the business, both in normal times (without crisis), but especially during crisis.

Further, our study is structured as follows: Section two reflects some stylised facts about the access to finance for SMEs and a brief reference to the specialized literature. In the third section we want to highlight the main types of financing used by the SME in 2011 in the new EU member states (Bulgaria, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland and Romania) and new measures proposed at EU level in order to improve access to financial markets. The study ends with conclusions.

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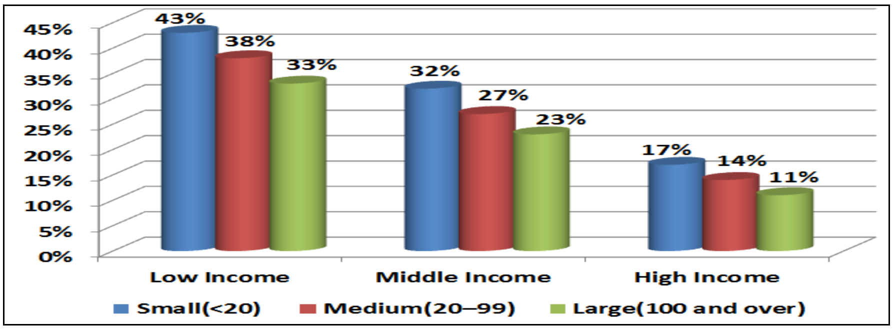
2. Stylised facts about the access to finance of SMEs and Literature review

Easy access to finance is crucial for companies, in general, and for SMEs, in particular, both for carrying out their daily activities and for realizing the investment activity but also for achieving the growth objective. The difficulties faced by SMEs when they seek to procure financial resources may prevent their current business processes and their development and even may constitute a major threat to national economies. The World Bank Enterprise Surveys, realized between 2006 and 2009, have shown that SMEs perceive access to finance as a major obstacle to their growth and development. Moreover, the results of the World Bank Enterprise Survey [International Finance Corporation, 2010, p. 22] show that a much higher percentage of SMEs in developing countries indicate the access to finance as a major obstacle in carrying out their activity (see Figure 1).



Source: International Finance Corporation, 2010

Figure 1: The percentage of firms that perceive access to finance as a major obstacle to growth and development

In the case of EU countries, according to the survey on the access to finance of SMEs in the European Union, conducted by the EC and the ECB in the period August-October 2011 [European Commission, 2011a], the access to finance for SMEs is, similar to 2009, the second most pressing problem for these companies while the most pressing problem for SMEs is still finding customers, fact that highlights the essential need for the adoption of measures by European and national authorities to further support SMEs, particularly by facilitating their access to finance.

In the case of the new EU member states analyzed in this study, the results show significant differences, so the highest percentage of firms reporting the access to finance as the most pressing problem are from Estonia (29%) while in Poland only 11% of the firms surveyed reported such a problem. It is also noted that in four of the eight studied countries the percentage of SME that reported the access to finance as the most pressing problem is above the EU average (see Figure 2).

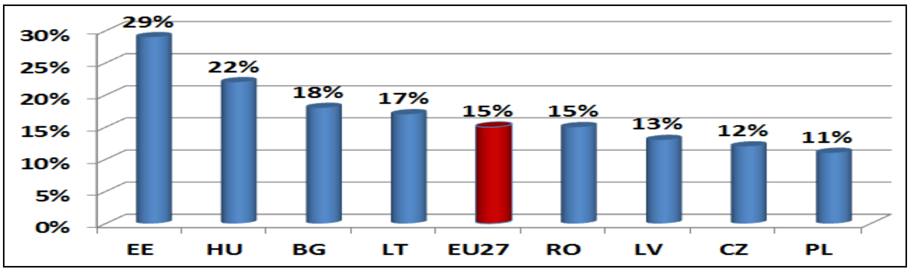
According to the literature devoted to the problem of firms financing, SMEs face a number of important constraints [Zavatta, R., 2008, Artola, C., Genre, V., 2011] when they pursue to procure financial resources, namely:

- The first obstacle is related to the *existence of informational asymmetries* between small firms and outside lenders or investors, which is giving rise to the so-called *adverse selection* when lenders or investors do not have enough information to allow proper evaluation of firms' financial performance and viability of their projects. Another problem caused by asymmetric information is the "*moral hazard*" when lenders or investors have provided financing but they cannot evaluate if the firm has used this financing in an appropriate manner. To alleviate these problems, it is worth noting that lenders and investors often ask for high interest rates, significant guarantees or refuse the request for financing from the firm.

- Another obstacle is related to the *high risk profile* assigned to small business. Providers of financial resources often consider SMEs as more risky compared to large firms because they operate in a competitive environment where the rates of return are uncertain and rates of failure are high.

- The existence of *significant transactions costs* which may appear when there is provided financing to a SME, such as, for example, the costs of evaluating of the demand for credit, registering property titles or the costs related to collateral evaluation.

- The *size of collateral required* it is mentioned frequently by the entrepreneurs as a significant obstacle which appear when they require a credit.



** All SMEs, % EU-27*

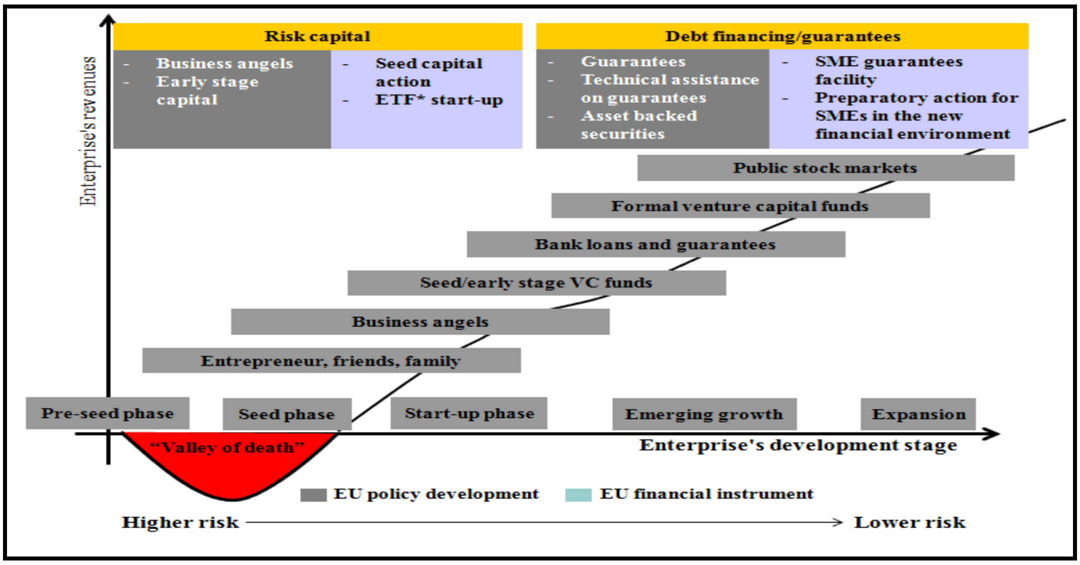
Source: European Commission, 2011a

Figure 2: The percentage of firms * that have identified the access to finance as the most pressing problem

3. Sources of SMEs financing and recent trends in EU

The sources of SMEs financing differ depending on the stages of their life cycle. For example, when starting a business or an innovative start-up, the personal savings of entrepreneurs, family and friends are the most important source of financing. As personal savings are reduced, the entrepreneur is forced to resort to external financing, which often is provided by business angels. In the early stages of life cycle, SMEs have a high risk profile and face significant barriers when they seek to procure financial resources, especially from banks and formal venture capital funds, which however can be attenuated by measures taken by European or by governmental authorities (see Figure 3).

To highlight the sources of financing of the European SMEs we consider the results of a survey conducted by the European Commission and the European Central Bank in order to provide information on the financial situation, financing needs, access to finance and expectations of SMEs. The survey on the access to finance of SMEs was conducted between 22 August 2011 and 7 October 2011 and included over 15.000 firms from 38 countries (27 EU member states and other countries of the European Free Trade Association or participating in the Entrepreneurship and Innovation Programme). The sample of companies analyzed for each country was divided into classes by their size, as follows: 30% - micro enterprises (1-9 employees), 30% - small (10-49 employees), 30% - medium enterprises (50 - 249 employees) and 10% - large enterprises (with 250 employees and over). Therefore, the results of this survey are illustrative for our study because micro, small and medium firms have the overwhelming share of 90% in the sample.



**The European Technology Facility Startup Facility (ETF Startup Facility)*

Source: Ernst & Young, 2011b

Figure 3: Life cycle of SMEs and financing instruments

The sources of financing used by SMEs in the EU27 including those in the studied countries are shown in Table 1. Across the EU27, is worth noting that 40% of firms use bank overdrafts, credit line or credit cards overdraft, 36% use lease or hire-purchase or factoring, 32% use trade credit and 30% use bank loans. In comparison, equity financing is used only by 7% of the SMEs and the main challenge concerning this source of financing is the lack of investment readiness or financial knowledge [European Commission, 2011a]. The results of the survey conducted by the EC and the ECB in the period August-October 2011, show that only about 25% of SMEs have used internal funds in the last six months (between April and September 2011). For the studied countries are noted some differences, Lithuania has the highest percentage of SMEs (30%) who used internal funds, while Estonia lies on the opposite side, where only 13% of SMEs have used this method of financing. Therefore, both in the EU27 and in the studied countries the external financing is the main source of SMEs financing, and within it stands the use in a significant proportion (overwhelming) of debt financing, especially through bank debt. A special situation is found in Lithuania where a higher percentage of SMEs (about 38%) used equity financing.

Table 1: Sources of financing used by the SMEs from the analyzed countries* (all SMEs, % by country)

	Bank overdraft[1]	Leasing[2]	Trade credit	Bank loan[3]	Internal funds	Other loan	Grants[4]	Equity
BG	30.9	23.6	29.1	22.9	18.2	14.4	7.0	4.2
CZ	36.4	40.1	17.8	26.3	27.3	17.4	16.3	2.0
EE	41.4	57.6	11.2	20.4	13.0	13.2	38.0	1.7
HU	32.8	35.0	13.7	25.1	26.1	17.4	12.4	0.7
LV	32.6	47.4	8.6	29.1	15.9	30.0	9.8	17.8
LT	28.2	38.0	33.3	27.6	28.9	27.1	15.1	37.9
PL	43.4	39.0	41.6	28.1	27.3	12.1	10.9	2.8
RO	42.5	36.3	39.0	27.2	25.5	21.9	9.9	3.4
Media	36.0	39.6	24.2	25.8	22.7	19.1	14.9	8.8
EU27	40.0	35.7	32.3	30.4	24.4	13.4	12.7	6.7

*in the category of SMEs financing sources are included also the subordinated loans, participation loans or similar financing instruments, and debt securities issued, but they are not reflected in the table because they are used in an extremely small extent by the SMEs in the analyzed countries; [1]including credit line or credit cards overdraft; [2]or hire-purchase or factoring; [3]new or renewal; [4]or subsidized bank loan.

Source: processing based on data provided by European Commission, 2011a

If we consider the types of external financing used by SMEs in the analyzed countries, the results show that in the last six months, on average in all analyzed countries only 17.26% of SMEs have applied for bank overdraft, credit line or credit cards overdraft, about 13 % have applied for bank loan, 10.36% for a trade credit and about only 9% of SMEs have applied for other types of external financing such as loans from other lenders, equity or debt issuance, leasing, factoring, etc. (see Table 2) .

Table 2: **Types of external financing that SMEs applied between April and September 2011* in the analyzed countries**

	EU27	LT	PL	LV	RO	BG	CZ	HU	EE	Media
Bank overdraft, credit line or credit cards overdraft	20.00	21.10	20.70	19.60	19.50	18.20	15.90	14.10	9.00	17.26
Bank loan[1]	18.70	12.50	14.80	17.30	13.50	14.60	15.40	9.10	4.20	12.68
Trade credit	14.80	16.10	19.10	10.10	14.50	8.70	8.60	5.50	0.30	10.36
Other external financing[2]	10.20	9.50	12.60	14.60	4.20	7.60	6.60	9.00	7.30	8.93

***** *All SMEs, % EU-27*; [1]new or renewal, excluding overdraft and credit lines; [2]loans from other lenders, equity or debt issuance, leasing, factoring etc.

Source: European Commission, 2011a and own calculation

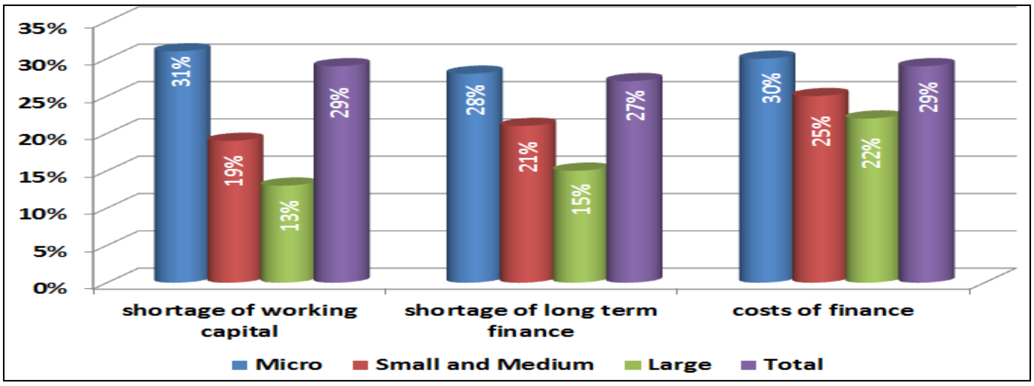
Although in Europe banks are financing 75% of the real economy [European Commission, 2011f], the firms and especially SMEs and start-ups face a number of difficulties when they want to obtain financing from banks. Moreover, in the context of the recent crisis, the access to finance has become more difficult as shows the survey on the access to finance of SMEs conducted by the European Commission and the European Central Bank. Thus, about two-thirds (63%) of SMEs in the EU27 which have requested a bank loan in the last six months have received all the required amount, 11% of applications were rejected, 17% received less than requested, and 4% refused the bank's offer because of the unacceptable conditions (see Table 3). In the countries considered in the analysis we observe that the previous mentioned percentages for the EU27 had other levels: 60%, about 14%, 3%, about 15% and 8% (see Table 3). On the other hand, the difficulties faced by SMEs when they resort to external financing present important differences between countries. Thus stands the situation in Latvia where only 46.30% of SMEs that have requested a bank loan in the last six months have received the required level. In terms of percentage of bank loan applications that were rejected there are countries which are far by the EU27 average: such a country is Estonia (about 27% of applications were rejected), Hungary (22.3%), Czech Republic (17%) and Romania (15.3%).

Table 3: The results of SMEs applying for bank loans in the analyzed countries

	Applied and got everything	Received less than they applied for	Applied but refused because cost too high	Applied but was rejected	DK/NA
BG	62.4	13.3	3.4	8.2	12.6
CZ	67.2	9.0	4.4	16.9	2.5
EE	68.3	4.9	0.0	26.9	0.0
HU	53.3	14.1	3.4	22.3	6.9
LV	46.3	39.1	0.0	8.8	5.8
LT	49.1	17.2	7.0	11.7	15.0
PL	70.4	5.4	5.0	8.6	10.5
RO	64.6	7.3	2.2	15.3	10.5
Media	60.2	13.7	3.1	14.8	7.9
EU27	62.9	17.0	3.7	10.9	5.5

Source: European Commission, 2011a

The recent global economic crisis had an extremely negative impact on the financing of European SMEs. Thus, based on The Enterprise Survey 2010 conducted in the final quarter of 2010 by EIM in cooperation with the European Commission [EIM Business & Policy Research, 2011] among the significant adverse effects of the crisis on the financing of the firms it stands *shortage of working capital* mentioned by 31% of micro-sized firms and by 19% of small and medium enterprises, *shortage of long term finance* which is reported by 28% of micro-enterprises and 21% of small and medium enterprises and *interest growth rate* reported by 30% and 25% of micro-enterprises and SMEs (see Figure 4). Therefore, micro-enterprises and small and medium enterprises face major difficulties in procuring financial resources.



Source: processing based on data provided by EIM Business & Policy Research, 2011, p. 163

Figure 4: The negative effect of the current crisis on enterprise financing, by size class, from EU27, in the period 2008Q4- 2010 Q4

The vital role that SMEs sector has for the development of the European economy and the crucial importance of easing access to finance to these firms for their exit from the crisis determined the European Commission on December 7, 2011, to present in an Action Plan the various policies that are pursued and which provide a greater support from the EU budget and European Investment Bank but also a proposed regulation of establishing some uniform rules for the marketing of venture capital funds [European Commission, 2011d]. The new proposed measures to support access to finance for SMEs are [European Commission, 2011c]:

a) On short term, i.e. for 2011-2013: *the adoption* (until June 2012) *of a simple and efficient regulatory framework for venture capital* in order to ensure the growth of the venture capital market size in the EU; *the revision by 2013 of the rules regarding the state aid for SMEs access to finance*, including the rules on risk capital so as to promote the objectives of Europe 2020 and to take into account the specific needs of SMEs; *the adoption* by the end of 2012 *of the new measures to improve access of SMEs on capital markets* in order to ensure an adequate level of protection for the investors; *the analysis* until September 2012 of *the impact on SMEs of new bank capital requirements*; supporting by the EIB Group of the growth of SMEs by improving lending to SMEs and SMEs access to venture capital; the adoption of measures to encourage the investors named "business angels" and to encourage cross-border investments; accelerating the application, before March 2013, of the late payments directive; taxation reforms for SMEs which mainly aims to eliminate tax obstacles for cross-border venture capital investments, preventing tax avoidance and evasion; *facilitating the access to microfinance* by increasing the supply of loans for micro-enterprises and promoting the adoption of the European Code of Good Conduct for Microcredit Provision;

b) On long term (2014-2020): European Commission proposal for the creation of EU Debt Financial Instrument for enterprises' growth and research and innovation, which will offer guarantees and other forms of risk sharing in order to encourage loans for SMEs, especially for SMEs focused on research and innovation; the European Commission proposal for the creation of EU equity Financial Instrument for EU enterprises' growth and research and innovation, which is destined to improve SMEs access to venture capital and other risk financing, from their early stage to their growth stage.

The crucial importance of the support of SMEs access to finance for European economic recovery can be highlighted by the declaration of the European Commission Vice President Antonio Tajani [European Commission, 2011d]: "e*asing access to finance for SMEs is priority number one to get out of the crisis*", and the fundamental objective pursued by the new measures proposed is "*to strengthen our EU financial instruments for SMEs and to improve their access to finance markets*".

4. Conclusions

Access to finance is one of the most important challenges for the creation, survival and growth of SMEs. A number of empirical studies and research reports indicate that access to finance is one of the most important barrier to progress and development of the business, both in normal times (without crisis), but especially during crisis. Moreover, the difficulties SMEs face when they pursue to procure financial resources constitute a threat to national economies.

In the light of the recent global crisis, the dramatic fall in demand for goods and services and the reduced availability of bank loans has led to the aggravation of the problems faced by SMEs when they prospect for purchasing financial resources. The Enterprise Survey 2010 conducted in the final quarter by the EIM in cooperation with the European Commission highlights the major negative effects of the crisis on the financing of the business: shortage of working capital, shortage of long term finance and the interest growth rate which indicates that European SMEs are facing difficulties in procuring financial resources.

In all EU countries including the new EU member states taken in the analysis we observed that bank financing is the main source of external financing for SMEs. However, SMEs face several difficulties when they use bank financing. Moreover, in the context of the recent crisis, the access to bank financing became more difficult as shown in the survey on the access to finance of SMEs conducted by the European Commission and the European Central Bank, during August-October 2011.

The vital role that SMEs sector has for the development of the European economy and the vital importance of easing access to finance to these firms for their exit from the crisis determined the European Commission to propose new measures to improve SMEs access to financial markets so to ensure recovery of the activity of these firms and thus the economic growth.

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