Access to External Finance

Background Study for the European Competitiveness Report 2014

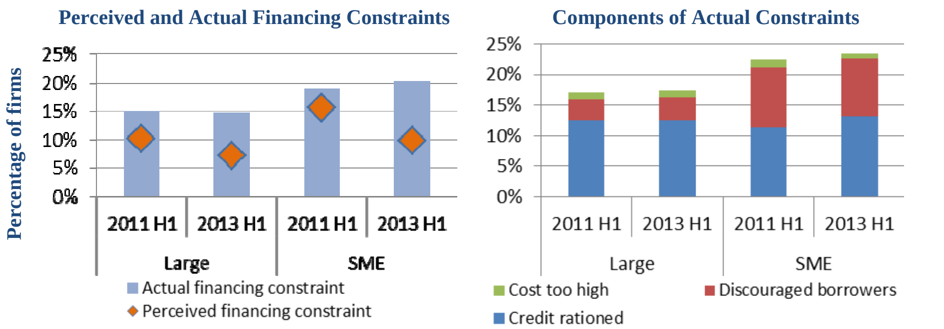
What we knew about external finance in the EU:

- Access to external financing is essential for EU enterprises to invest, innovate and grow.
- The proportion of bank loan acceptances has fallen significantly along with the level of enterprise investment.
- Many SME's report difficulties in obtaining external finance.

What we wanted to learn:

1. Do some types of firms find it more difficult to borrow than others even though their financial performance is the same?
2. How important are bank loans, and other financial factors, for the growth of firms, in terms of supporting investment, employment, productivity and exports?
3. Are certain types of firms and industrial sectors more reliant on borrowing than others?

What we discovered:



Source: ESRI analysis of ECB SAFE data.

- The proportion of bank loan acceptances has fallen significantly along with the level of enterprise investment. The sharpest falls have been in countries hardest hit by the crisis. There are still substantial cross-country disparities in lending conditions[1], with Italy having the tightest credit standards.

- Based on the findings of an econometric analysis of ECB survey data and EU firm accounts, from the Amadeus and Efige datasets, **the difficulties that small and young firms have in obtaining external finance is not linked to risk.** Even if their financial performance is the same, small and young firms find it more difficult to obtain bank credit compared to other firms. **This indicates that the market for bank credit is not functioning efficiently**. The *market imperfections* are thought to stem from ***information asymmetries***. On the one hand, banks may not have sufficient financial information on firms who want to borrow, which is discouraging them from lending. On the other hand, firms may not have sufficient knowledge of potential lenders or may be discouraged from borrowing due to a belief that banks will not lend to them, so they will miss out on borrowing opportunities.

- **Lending is more important to small and young firms to finance new investment**, compared to other types of firms. However, as noted above, small and young firms find it more difficult to obtain loans. Also, **small and young firms are more sensitive to the interest burden on loans**, compared to other types of firms**.** Because young firms, in particular,

[1] Q1 2014 ECB bank lending survey.

have difficulty obtaining long term credit, they are being driven to accept shorter term credit arrangements, which are unsuitable for funding long term investment projects.

- Long term credit is very important to all firms for them to take on new staff. Domestic-owned SMEs and very small (micro) firms depend on long term credit the most to expand their workforce.

- In general, rising firm productivity (TFP – total factor productivity) is strongly associated with increasing cash flows.

- Firms which are less financially constrained are more likely to export, possibly because these firms have the available funds to overcome the sunk costs of entry into export markets. However, financial constraints do not affect the export sales (intensity) of those firms that are already exporting.

- In terms of sectors, access to external finance is more important as a driver of new investment for manufacturing and construction sectors than for services. In terms of enabling new employment, the high-tech knowledge intensive services sector is more reliant on external finance than other sectors.

Policy Implications

- The following policy implications are drawn, primarily, from the findings of the study, as well as discussions with ENTR/D3. The ECB and the EIB/EIF were consulted during the study on policy actions to improve access to external finance.

- The findings enforce two main messages: small and young enterprises suffer from imperfections in the market for bank lending and they are also the groups of firms that benefit the most from such lending to drive firm growth. These facts point to the need to provide affordable long-term credit to these groups of enterprises. This need is reinforced by the fact that small and young firms are more sensitive to the interest burden on loans than other types of firms.

- On the side of lenders, traditional policy support mechanisms such as loan guarantees, risk-sharing initiatives and direct loan facilities are able to help small and young enterprises obtain credit. In addition, public support for other sources of financing, such as equity financing in the form of venture capital financing, for small and young firms, also helps mitigate against the disadvantages that these firms face in the market for bank credit, by diversifying the sources of finance available to them. Information asymmetries could be addressed by standardising the financial information on SMEs through the establishment of, for example, centralised credit rating agencies, on a national or EU level. These could be used as a source of reference by all banks, similar in purpose to the credit ratings issued on government, municipal and corporate debt.

- On the side of borrowers, policy measures should be introduced that boost the market knowledge of small and young enterprises, as well as training in the preparation of loan proposals.

- Companies need additional financial resources to export. Hence specific financial policy measures are warranted to help companies to export. These could be in the form of export credits and insurance, or other measures.

- Given the variation in the severity of the financial crisis across countries, policy measures and instruments to improve SMEs' access to external finance should take into account country specific conditions, i.e. priority should be given to policy support in those economies worst affected, whilst maintaining the need to support viable enterprises.

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