# TRADITIONAL VS MODERN FINANCING TECHNIQUES FOR SMES - A GLOBAL PERSPECTIVE

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**Abstract:** In all stages of life cycle for the Small and Medium Enterprises (SMEs) - creation, survival and growth - it is necessary the access to financing sources. Even the bank financing almost recovered after the international financial crisis, the SMES still have to face structural challenges and market failures, information asymmetries, high transaction costs, lack of financial skills and training of small business owners. Beside the traditional forms of financing (credit loans, overdrafts, credit lines) there is a need of new and modern financing tools for SMEs in order to cover a wide range of financing needs, to increase the SMEs flexibility and adaptation to challenging situation on financial markets. Therefore, the alternative financing instruments - asset-based finance, alternative debt, equity instruments and hybrid instruments - could offer new opportunities for the SME financing needs.
In this paper are presented the main characteristics of the alternative financing instrument in comparision with the traditional financing techniques, the main barriers faced by small and medium firms in accesing the financing sources and the recend measures adopted by the governments to improve the access to finance for SMEs.

**JEL classification: G32, L21, M21**

Key words: traditional financing, alternative financing, factors, trends

## 1. INTRODUCTION

Access to finance is a critical condition for new creation and future development of small and medium enterprises (SMEs) (Beck, 2007). But the latest challenges (international financial crisis, increased competition, volatility of exchange rates, interest rates evolutions, political and social issues) cause new limits for access to financing and therefore limit their creation and growth in many countries. There is also a problem of demand and supply in financing SMEs which involve the actors, institutions and technologies used in financial markets (Di Noia&all, 2015). The last evolutions do not indicate an increase of credit flows towards SMEs because the reduced credit demans and investment opportunities, rigorous prudential rules and selection criteria (OECD, 2018b).

One of the traditional source of external finance for many SMEs consist on banking lending, which are often used in order to achieve their cash flows and cover the investment needs. But the tranditional banking tools still face challenges for the SMEs in the starting phase, but also for the innovative and growing firms with higher risks or firms with importants changes in their activities: ownership, control, or capital structures.

Besides, the external factors (such as financial crisis, increased competition) determined the firms to strenghten their capital structures and to decrease the level of loans.

As long as the bank financing are crucial for the SMEs, there is a general concern that they should accept the credit constraints imposed by the banks. Therefore, there is necessary to use a wide range of financing instruments by SMEs, in order to enable them to set up, grow and develop on the market.

Thus, beside the traditional forms of financing (credit loans, overdrafts, credit lines) new and modern financing tools are available for SMEs in order to increase the SMEs flexibility and adaptation to challenging situation on financial markets and to improve their contribution to economic growth, job creation, innovation, investment and competitiveness increase (Biggs, 2002) (Newberry, 2006).

Therefore, the alternative financing instruments could offer new opportunities for the SME financing needs (Udell, 2015). At present, there is an increasing range of financing options for SMEs, which can be grouped as follows: alternative debt, asset-based finance, equity instruments and hybrid instruments and their main features (characteristics, factors, trends, support policies) will be outlined in in this paper.

## 2. Traditional vs modern financing instruments – theoretical fundaments and evolutions

Traditional debt finance - bank loans, credit lines, overdrafts - is the most common source of external finance for many SMEs (figure 1). In general, traditional debt finance is used for low or moderate risk firms as long as it generates moderate returns for lenders.It generally support the regular activity and short-term needs of SMEs, characterised by tested business models, stable cash flow and growth, access to collateral or guarantees (Berger and Udell, 2006).

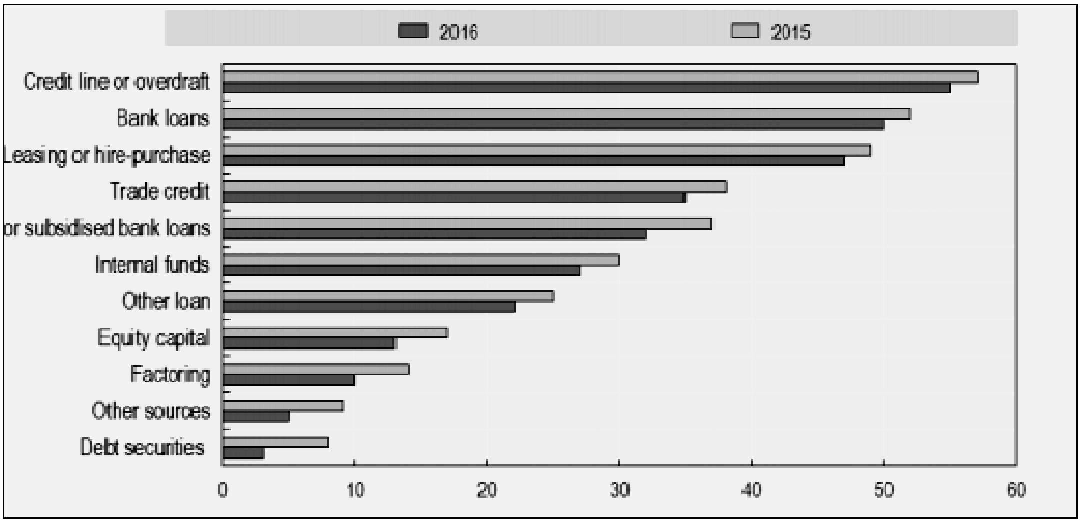


**Figure 1. The importance of financing sources for SMEs (EU 28) (%)**

*Source: EC, Survey on the Access to Finance of Enterprises in the euro area, 2017*

The traditional debt instruments represent a claim on the borrower, who must pay in return an interest to the creditors (fixed or adjusted rate) at specified intervals, regardless the financial situation of the company or the investment return. This debt does not include any specific features (i.e. it cannot be converted into another asset) but the bank claims have priority in the case of bankruptcy.

After many years of growth, at the global level, the medium value growth rate in new SME lending decrease with about 6% from 2015 to 2016 (figure 2).

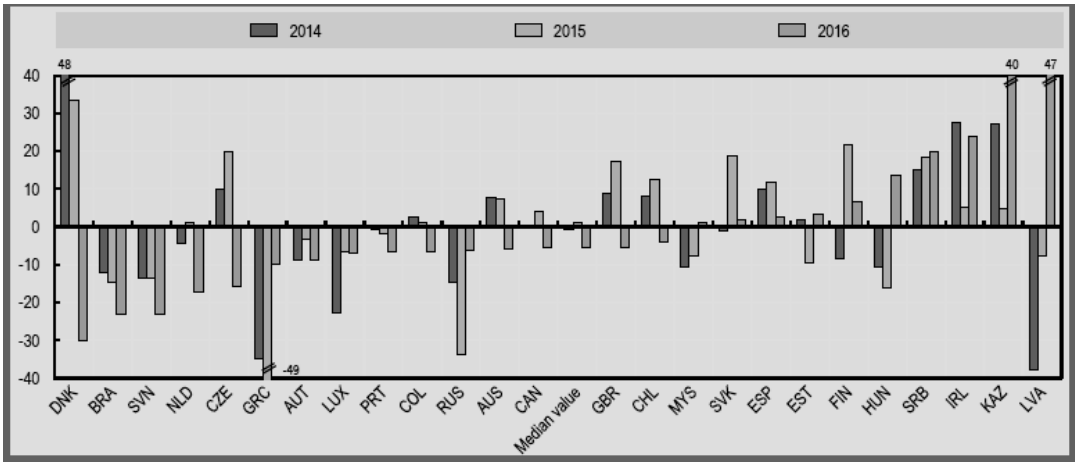


**Figure 2. Trends in SME lending (yealy growth rate, %)**
*Source: OECD, Financing SMEs and Entrepreneurs, an OECD Scoreboard, 2018*

The decrease of the lending volumes are caused by several factors: lower demand for credit, reduced investment dynamic (Australia, Austria, Czech Republic, the Netherlands, United Kingdom), high levels of non-performing loans, the reluctance of the financial institutions when lending to SMEs because of risk (Greece, Slovenia and Portugal), unfavourable macro-economic conditions (Brazil, Russian Federation).

Although the recent trends indicate a reduction of credit conditions, there are still high differences between countryes regarding the rejection of the credit demand (from about 27% in Serbia and Korea, to 2.5% in Austria) (Figure 3).

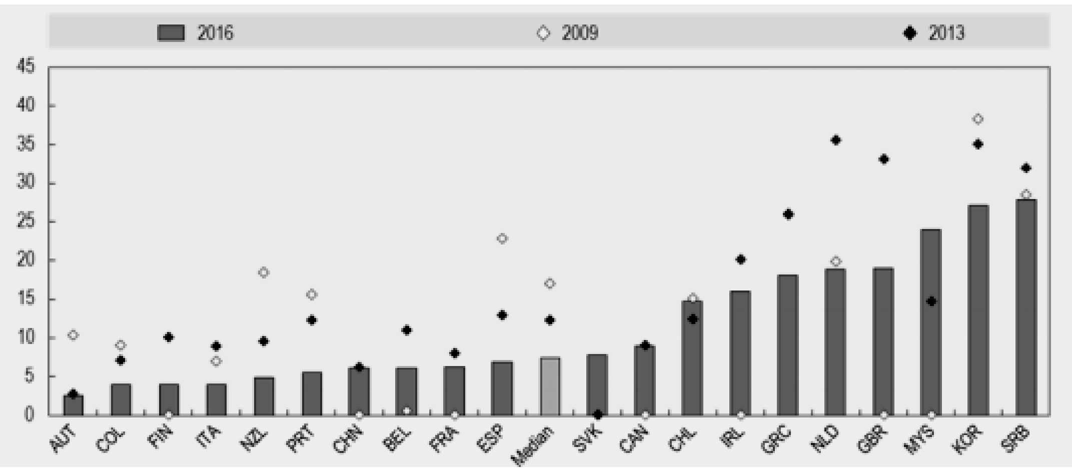


**Figure 3. Loan rejection rates for SMEs (as percentage)**
*Source: OECD, Enhancing SME access to diversified financing instruments, 2018*

In traditional finance, for the lender it is important the creditworthiness of the firm but the tehnicques used to assess this can vary significantly. There are different lending mechanisms that combine various information sources regarding the borrower, structure of the loans or monitoring strategies and they can be classified in:

- financial statement lending (transaction lending) which is based on available and reliable financial statements, characteristic for transparent firms;
- small business credit scoring (relationship lending) which is based on historical information about the SMes owner and the company, characteristic for non transparent firms (Berger&Udell, 2006).

While the large banks are more involved in transaction lending types, the small banks pay more attention to the relationship type and they can have a comparative advantage in this lending type compared to the large banks (Berger&Black, 2011).

The SMEs have to face specific challenges when access traditional lending. And one of the most importat consist on the difficulties that lenders face when have to assess and monitore the SMEs in comparision with the large firms, such as (OECD, 2013):

- asymmetric information - is a serious problem for SMEs compared with the large firms because the SMEs often do not produce audited financial statements, often there is no separation between the finances of the owner and of the business, there are missing the corporate governance principles;
- the principal- agent issue, which appear in special in the case of small businesses. Compared to the large firms which can sellect a appropriate tehnique for sharing risk and returns, the range of option for the SMEs are norrower.

The global financial crisis and its implications determined the governments to adopt measures in order to support the SMEs' access to finance and the most interventions were focused on reducing the credit constraints, especially by loan guarantee schemes and direct lending programmes. In these circumstances, there are necessary more diversified options for SME financing in order to reduce the growth capital gap, to support the investment, to reduce the SMEs vulnerability to challanges on the credit market, and to better adapt to a changing regulatory environment.

At present, beside the traditional forms of financing there is a need of modern financing instruments for SMEs in order to cover their inceasing financing needs (Udell, 2015). Therefore, the alternative financing instruments represent a modern option for the small and medium enterprises all over the world (figure 4).

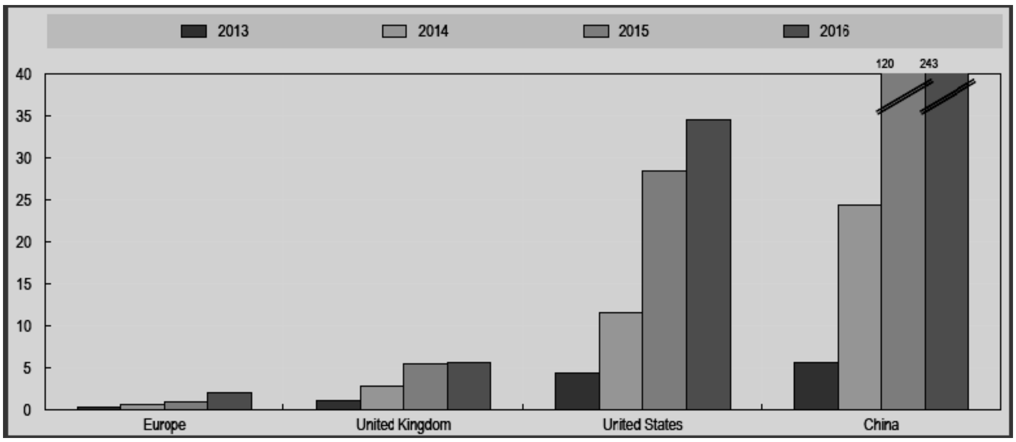


**Figure 4. Total alternative finance market volumes by world region (USD, billion)**

*Source: OECD, Financing SMEs and Entrepreneurs, an OECD Scoreboard, 2018*

There is a wide range of financing techniques available to SMEs, which can be grouped as follows (OECD, 2018b):

- asset-based finance (asset-based lending, leasing, factoring, purchase order);
- alternative debt (corporate bonds, securitized debts, crowdfunding, covered bonds, venture debt);
- hybrid instruments (convertible bonds, subordinated loans/bonds, participating loans, profit participation rights, mezzanine finance);
- equity instruments (private equity, venture capital, business angels).

With a low risk and return spectrum are the asset based finance tehniques that sustain the short, medium and long term financing needs of SMEs, but that have a different mechanisms than traditional debt.

The keys factors that distinguish asset-based lending from traditional lending is that the firms can access money faster and can provide more flexible terms than traditional lending and it not based on its the credit standing, but on the value a specific asset could generate in the business.

On the other hand, the costs involved and the complexity of procedures may be higher that those associated with traditional bank loans, including asset evaluation, auditing, monitoring and other legal costs. Also, the credit limits are often more reduced than in the case of traditional debt.

Asset-based finance is widely used by SMEs from developed countries, and increasingly in emerging economies, in order to cover their working capital needs and for investment purposes. The asset-based finance registered an increase over the last decade, despite the negative effects of the international financial crisis on the supply side.

The alternative forms of debt are also low risk/return financing tehniques, they can be considered innovative for the SME financing and include (OECD, 2018b):

- corporate bonds which are direct instruments of debt finance for SMEs. But in general, few SMEs had succes on issuing corporate bonds, because of difficulties faced in fullfiling the investor regulations and the high cost for bond issuance;
- securitised debt and covered bonds represent an indirect tools for supporting SME debt financing. In the last decade, securitised debt has grown rapidly because the securitisation of debt which allows banks to transfer their credit risk to the capital markets.

At the medium level of the risk/return are placed the financing tools that allow an investor to accept a higher risk for more return. They are hybrid instruments, such as mezzanine finance, considered as a bridge between traditional debt and pure equity.

Equity finance are related mostly for firms with a high risk-return profile (new and innovative SMEs) and can be used for seed and early stage firms. Also, the business angels could play a significant role for firms creation and development stage of the firms.

The alternative financing sources represent new opportunities for SMEs but also involve some levels of risks. Therefore, the governments launched new initiatives all around the world in order to ease access to various sources of finance, such as: credit guarantees; stimulation of crowdfunding activities; changes of financial regulation for online platforms or development of digital tools for customers protections.

## 3. Conclusions

The access to finance still renain one of the most important problem faced by SMEs. Although the access to banking finance largely recovered after the financial crisis, the SMEs confront with many factors which limit their access to finance, such as: the market failures, structural challenges, information asymmetries, high transaction costs, lack of financial skills among the entreprenrours.

In these circumstances, it is a need to widen the range of alternative financing for SMEs (asset-based finance, alternative debt, equity instruments and hybrid instruments), in order to fulfill the financing needs in different circumstances and thus, improve their contribution to economic growth, job creation, competitiveness and innovation.

Despite the fact that bank financing will continue to be the most important financing source for SMEs, the different alternative financing instruments could offer opportunities to meet the more diversified SME financing needs. However, their potential remains underdeveloped in most countries because the SMEs confront with some barriers in order to benefit of such diversified alternative financing tools.

Till now, a lack of awareness and understanding on these alternative instruments by part of SMEs, financial institutions and governments represent a step backward for their broader use. In that sense, it is necessary an improvement of knowledge of the alternative financing instruments for SMEs and development of their skills and strategic vision for financing needs; develop an appropriate regulatory framework for the development of instruments that imply a higher risk for investors than traditional financing tools; increasing markets transparency; addressing information asymmetries; cover the information gap between SMEs and investors by facilitating their interaction; implementing policies that attract private resources and develop some risk-sharing mechanisms with the private sector.

Only applying these measures, a more diversified set of alternative financing options can contribute to the reduction of the systemic risk and to enable SMEs to continue to play their role in growth, employment, investment and innovation.

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