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CONTROL RELUCTANCE AND LEGITIMACY FOR SMES APPLYING BANKLOANS

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SMEs attitude versus external financiers, mainly bank loans, is a constant subject of change, especially for transition economies because it is critical to SMEs' success in exploiting, indeed surviving, the rapid globalization of markets. The circumstances under which SMEs may accept outside control, evolving towards more openness, are determined by their financial status, the development of technology, size and growth needs. The enterprises' legitimacy, determined by professional management practices, networking and growth stage, positively influences SMEs' accessibility to bank financing.

Key words: outside control reluctance, financial status, growth stage, bank financing, legitimacy

At the beginning of the transition period in Central and Eastern Europe (CEE), most enterprises were inefficient and large, the market being characterized by the absence of small and medium enterprises (SMEs). These changed after privatization and restructuring of state-owned companies. New small firms quickly developed. Nowadays the SME sector is the generator of job creation and the core of foreign exchange through exports, being constantly encouraged and even placed at the heart of European Union's future economic prosperity.

Still, the SME sector in CEE remains underdeveloped. Although this sector obtained the higher net profits referred to the total turnover, the opportunities of financing this sector are limited to uncertainty, caused by their short track record and history, few published financial information and the fact that banks perceive them as having a greater credit risk. Unable to raise external financing means, SMEs are forced to rely on internal finance, which is a constraint factor to their growth.

Furthermore, financial systems in CEE countries are not functioning properly. EBRD's 2004 report demands an improved access to finance for SMEs and a wider diversification of the financial product range available to SMEs.

1. Control reluctance and bank loan requests

Small business managers are extremely sceptic on new external finance. But over-reliance on internally generated funds imposes a major constraint on economic growth.

It was proved that firms seem to adopt a stable order of preference for different sources of finance: firstly internally generated funds, secondly bank loans and just finally new equity from external partners. A SME in need of financing sources will most probably follow this order. Moreover, as positive a firm perceives external financing to be, it is more likely that it'll actually seek financing from a bank.

The circumstances under which SMEs are prepared to accept outside control in the business in order to grow, accepting external finance, are determined by the development of technology, financial status, dimension and perceived need to grow.

The development of technology

Technological development and the impact of new production methods shape many industries. In order to ensure prosperity, indeed survival in a transition economy, SMEs must invest in emerging technologies and raw material.

Countries in CEE have to keep up the pace with the developed Western European countries, so investments are injected in new technologies and information, all in the spirit of technological progress. It becomes imperative to acquire even external financial backing to support investments in brand new technology and machinery.

Financial strength

The actual financial status of the firm seems to influence the attitudes entrepreneurs have, and the actions they take. Cressy has used the concepts of "movers" and "stayers" (Cressy, 1995). Movers experience large levels of external financing, having a high profitability, but assuming higher risks. Stayers are conservative and have risk aversion, experiencing low levels of external financing, that further leads to low profitability.

The aversion some entrepreneurs have to external finance arises from the control reluctance from the change of ownership. Firms will not allow themselves to invest, unless it is absolutely certain that all needed capital can be generated without generally compromising the existing balance between internally versus externally originated funds.

The financial weakened status of a firm will positively influence its attitude towards external financing.

Size and Growth

Young firms in dynamic sectors tend to grow faster. Furthermore, growth is limited as much by the psychology of the entrepreneur as by the financial resources. The need to grow in order to survive sets the attitude towards external financing.. If entrepreneurs do believe that growth is necessary, then they will probably ensure survival by whatever means. Their ambition to grow is also related to the financial search activity. A strong ambition to grow in the number of employees leads to a greater need for capital, making these firms more active in searching for new financiers when the internally generated funds are insufficient.

When firms grow, their ability in resource generation increases, but they also encounter new financial challenges and new expectations as well. This usually leads to more elaborate relationships with financial institutions, including credit institutions, further leading to an increased awareness of the possibilities offered by bank financing. The larger the firm, the more positive will it perceive the use of external financiers.

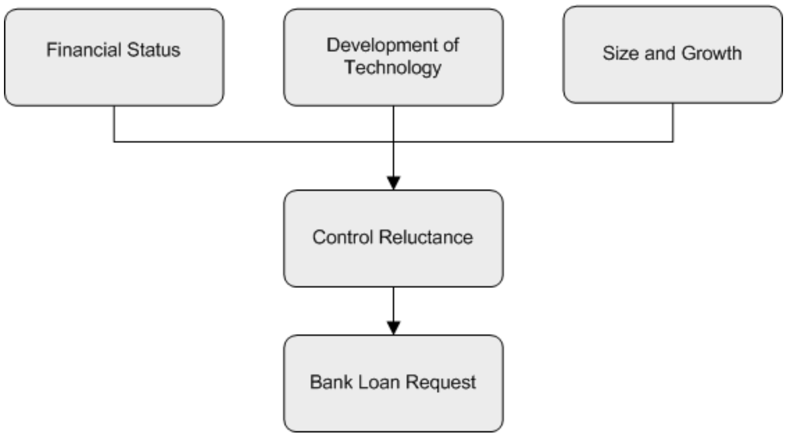

Figure no. 1 Control Reluctance versus Bank Loan Request

To conclude with, size, technological development, growth pressure and financial weakness are all directly correlated to a change in control aversion and, subsequently, to an actual change in the type of financing sought. Control aversion resides in the fact that entrepreneurs think that their financiers represent a threat to their control of business' operations. This widespread skepticism to external control hinders many SMEs from financing their actions, from increasing their number of employees and ultimately from growing.

Does it worth paying the price of remaining control reluctant and thus depriving the firm of the benefits of a bank loan?

2. Determinants of Getting Bank Financing

The private sector appears as a new lucrative market for commercial banks wishing to diversify their loan portfolios.

On the other hand, external financing is a critical source of funding for firms in transition economies. However, private firms in CEE face an extremely challenging task in accessing external sources of finance.

In the absence of effective market institutions and infrastructures, reliable business data, and established reputation of working with banks, some more questions are raised: are SMEs high-risk borrowers? And how canbanks be persuaded to provide SMEs with the needed loans?

Growth stages

Firm legitimacy is a function of age. New firms suffer from "liability of newness". The lack of knowledge and acceptance of new firms means their legitimacy is weaker than more established firms. So, obtaining legitimacy is central to the process of survival of new firms.

The growth of firms is neither a smooth, nor a gradual process. Various growth stages have been established. Firms at the early stage have not established their reputation on the market and are subject to a higher rate of failure than their counterparts in the later stage. So, firms in the early growth stage are expected to have disadvantages in accessing bank loans.

Professional management practices

Top management practices become more and more widely used by private firms as the economies move toward more market-oriented systems. Best practices borrowed from market economies will positively help SMEs in emerging economies to gain legitimacy. The effort of "professionalizing" their image through the adoption of best management practices is particularly important to access bank loans.

Connections

Extremely important for SMEs are the social connections established by a SME: with government officials and with managers of other firms and with friends or relatives. Social networks have been proved to be especially important in transition economies to obtain the SMEs' necessary level of legitimacy. In CEE, inter-personal relationships stand for spreading information about the firm's existence and its practices. It also helps the firm to get support from key stakeholders and the public. A firm's connections with government officials are negatively correlated with bank loan accessibility because the support subsidies programs offered by the government are less expensive than bank loans. On the other hand, the strength of a firm's connections with others are positively related to the bank loan accessibility.

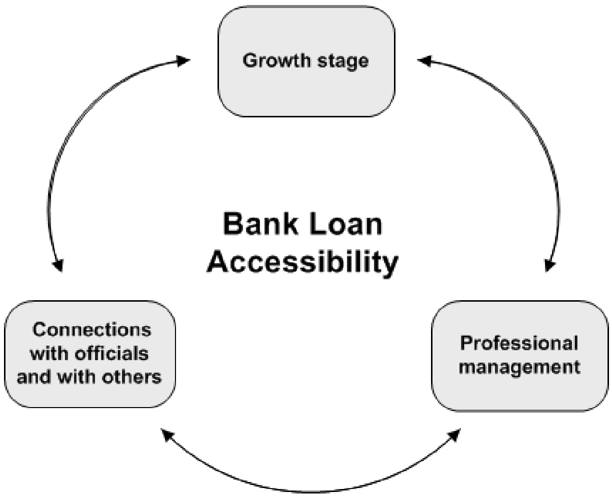

Figure no.2 Determinants of Getting bank loans for SMEs

These three determinants for the accessibility of a bank loan are also inter-related. SMEs at an early growth stage started by establishing positive connections with managers of other SMEs and with friends or relatives, and haven't developed strong bonds with government officials yet, so cheaper government subsidies are not available to them, making them more eager to apply for a medium to long term bank loan, as it was previously stated. SMEs found at a larger growth stage have proved their legitimacy, thus improving networking with government. Moreover, professional management policies are stronger for firms at a larger state of growth.

The impact of institutional and civilization context on merchant bank financing for private firms follows the above presented determinant trends. Still, certain peculiarities may clearly show in cross-national regions of CEE.

Conclusion

The private sector is thought and expected to be the engine of economic development in CEE economies. In constant need for external financial resources, SMEs have an extremely difficult time demonstrating their creditworthiness in front of merchant banks, when applying for a medium or long term loan. Networking and professional management practices help SMEs to solve this issue. Having considered in turn both SMEs' and banks' point of view, in time, the private sector is believed to become more and more competitive.

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