

# IMPACT OF THE GLOBAL FINANCIAL CRISIS ON COOPERATION BETWEEN SMEs AND BANKS

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## **Abstract**

The sector of SMEs plays a key role in the economic development in Poland. On the other hand they belong to the group of units which is characterized with the weakest position in the market. Practice and theory show that SMEs seek for the financial means for running their activities and for investments. The problem with the financing strongly appeared in the time of the financial and economic crisis, when SMEs and entrepreneurs have suffered a double shock: a drastic plummet in demand for goods and services and the tightening in credit terms, which were ruthlessly disturbing their cash flows.

**Keywords:** SMEs, financing, financial crisis, relations

## **1. Basic concepts**

Micro, small and medium-sized enterprises are socially and economically important, since they represent 99.8% of all enterprises in Poland. “SMEs” mean micro, small and medium-sized enterprises<sup>3</sup> within the meaning of Recommendation 2003/361/EC in the version of 6 May 2003 (see Table 1).

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<sup>3</sup> An enterprise is considered to be an entity engaged in an economic activity, irrespective of its legal form. This includes, in particular, self-employed persons and family businesses engaged in craft or other activities, and partnerships and associations regularly engaged in an economic activity.

**Table 1.** Definition of micro, small and medium-sized enterprises

<b>Enterprise category</b>	<b>Headcount</b>	<b>Turnover (in million EUR)</b>	<b>Balance sheet total (in million EUR)</b>
medium-sized	< 250	≤ 50	≤ 43
small	< 50	≤ 10	≤ 10
micro	< 10	≤ 2	≤ 2

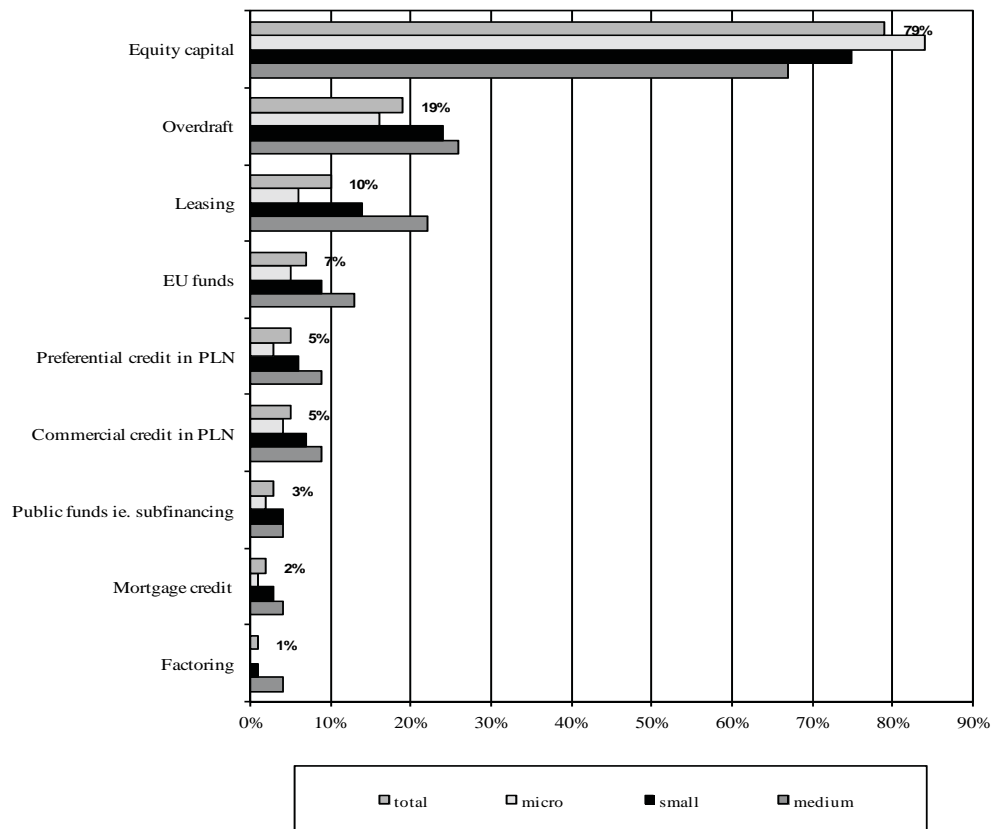
*Source:* Commission Recommendation of 6 May 2003 concerning the definition of micro, small and medium-sized enterprises notified under document number C(2003) 1422, 2003/361/EC.

The sector of SMEs plays a key role in the economic development in Poland. But even if the role of SMEs is so significant in Polish economy, their position on the financial service market is rather weak. SMEs seek for the financial means for running their current activities and for investments. On the other hand, looking from the banks' point of view SMEs are perceived as clients of a higher risk level. The banks find the biggest problem in: insufficient collaterals, lack of consumer's creditworthiness, low investment perspectives and problems in preparing good business plans. Analysing the marketing strategies implemented by banks in Poland, it can be said that more and more of them treat SMEs as the target markets and they are interested in selling them a package of services and products tailored to meet their needs.

In this paper the authors concentrated on the impact of the global financial crisis on the terms and condition of cooperation between SMEs and banks in Poland.

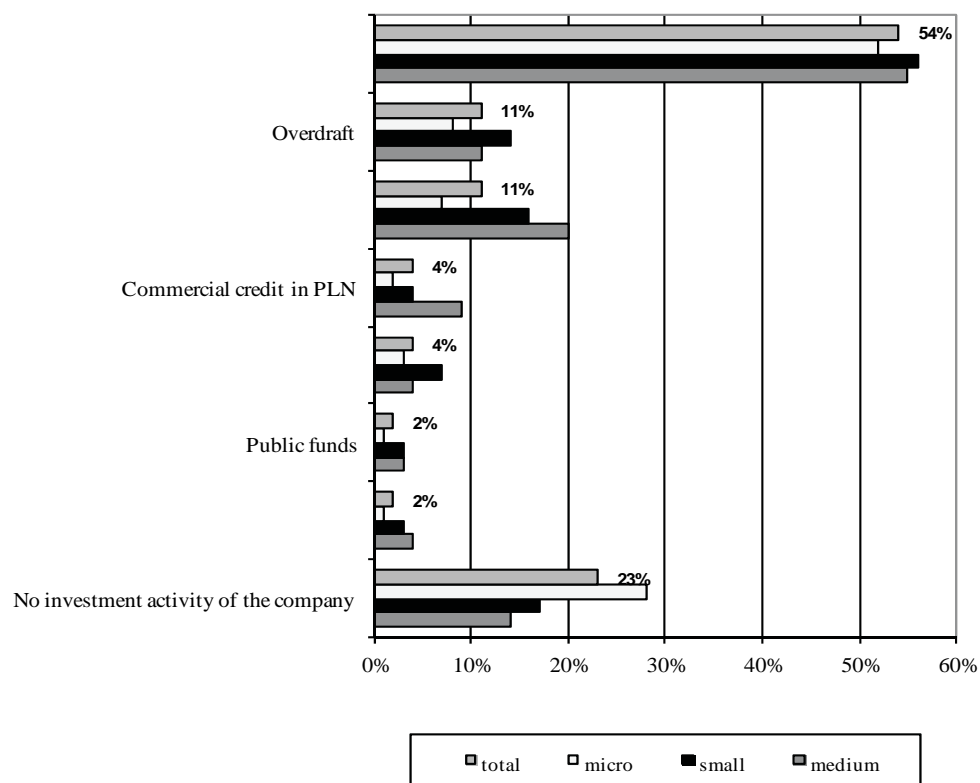
## **2. Sources of financing for SMEs**

SMEs belong to the group of units which is characterised with the weakest position in the market. Practice and theory show that SMEs seek for the financial means for running their activities and for investments. Market research done by Pentor in 2010 (sample of 1400 SMEs in Poland) shows that majority of SMEs finance their current activity and investment using equity capital (correspondingly 79% and 54% indications – see Fig. 1 and 2).



**Figure 1.** Sources of financing of the current activity by different types of SMEs (in % of indications). *Source: Audyt bankowości Mikrofirm 2010, Audyt bankowości MSP 2010, Pentor Research International, May 2010*

Respondents also pointed credits as the outer source of financing most often used: overdrafts, commercial and preferential credits in Polish zloty as well as European and public funds. Besides the loans, companies make also use of leasing and factoring, even if it is more expensive source of financing.



**Figure 2.** Sources of financing of the investment activity by different types of SMEs (in % of indications). Source: *Audyt bankowości Mikrofirm 2010*, *Audyt bankowości MSP 2010*, Pentor Research International, May 2010

### 3. SMEs and the Crisis

The basis of the economic boom in Poland in 2004–2006 was the integration process with the European Union through the enlargement in 2004. This evolution enhanced private sector confidence and improved business climate. The economic turnaround developed to the boom thanks to financial markets. The access to financing is one of the most important challenges for the creation and development of SMEs, especially innovative ones<sup>4</sup>. Until 2007 credit demand increased severely because of high permanent income expectations and inexpensive costs of loans offered by the supply side.

<sup>4</sup> Survey on the access to finance of SMEs in the euro area, 1 December 2011, report on the results of the survey on the access to finance of small and medium-sized enterprises in the euro area – April to September 2011, European Central Bank, <http://www.ecb.int/press/pr/date/2011/html/pr111201.en.html>. The survey is conducted jointly by the ECB and the European Commission. It includes a set of questions on SMEs' growth and the obstacles they believe may hinder their growth.

The problem with the financing strongly appeared in the time of the financial and economic crisis, when SMEs and entrepreneurs have suffered a double shock: a drastic plummet in demand for goods and services and the tightening in credit terms, which were ruthlessly disturbing their cash flows<sup>5</sup>. What was more problematic, at the money market there appeared total aversion to risk, due to which the banks did not lend money even the other banks (Brei et al., 2011). It effected in further drop in private consumption and demand for investment goods and as well in the huge increase in market uncertainty.

Drastic changes in exchange rates, stock exchanges' indexes level fall and rise in interbank loan interest rates developed the increase in the prices of financial instruments and made access to money difficult. All these factors influenced the growing instalment loans paid in tranches by SMEs to the banks, and therefore, lack of liquidity and trust between the parties, cooperating previously in the legally approved way. The problem of confidence and reliance was connected with the fear of SMEs against their exposure for losses and eventual bankruptcy. Not only the SMEs were hit by lack of confidence, also the banks did not believe each other's declarations towards common arrangements at the money market.

The critical situation, associated with the bankruptcy of Lehman Brothers in September 2008, made the crisis spread in all the countries through the channels of the financial system. It performed in two ways: either by shifting credit crunch to investment or by the fall in consumption level caused by debt inflation in private consumer and SMEs loans. The direct effect, which was the freezing up of global financial flows and the decreasing volume in trade, impacted both the SMEs and the banks.

It is important to stress that SMEs are generally more vulnerable in the times of crisis for many reasons. It is more difficult for them to downsize as they are already small and individually less diversified in their economic activities. They have a weaker financial structure (i.e. lower capitalisation) than big corporations and a lower or no credit rating. Furthermore, SMEs are heavily dependent on credit facilities and they have fewer financing options<sup>6</sup>.

The most of loans offered by banks to SMEs in Poland are based on such volatile interest rates like LIBOR 3M EUR (London Interbank Offered Rate on a basis of 3-month deposit rate, specified for euro, the quotation of which is made by the banks located in London and published by British Bankers' Association) and WIBOR 3M (Warsaw Interbank Offered Rate, on a basis of 3-month deposit rate in Polish zloty). In the time of the crisis LIBOR 3M EUR started to rise and in the period of twenty months, until August 2008, it doubled the level from January 2006 (see Fig. 3). The level of WIBOR 3M grew up even more rapidly and it reached 6.62 in the end of September 2008, what – comparing to April 2007 with

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<sup>5</sup> *The Impact of the Global Crisis on SME and Entrepreneurship Financing and Policy Responses*, OECD, Centre for Entrepreneurship, SMEs and Local Development, June 2009, p. 6.

<sup>6</sup> *Ibidem*, p. 7.

the level of 4.31 – meant the 150% increase in a base interest rate for the credits facilities (see Fig. 4).



**Figure 3.** LIBOR 3M EUR fluctuations in the period of 2006 – I quarter of 2011. *Source:* <http://www.money.pl/pieniadze/depozyty/walutowearch/>, 31 March 2011



**Figure 4.** WIBOR 3M fluctuations in the period of 2006 – I quarter of 2011. *Source:* <http://www.money.pl/pieniadze/depozyty/walutowearch/>, 31 March 2011

SMEs' heavy reliance on bank credit meant that they were particularly vulnerable to such swings<sup>7</sup>. The decline of the basic interest rates level in the end of 2008 has given the relief in the balance sheet of SMEs, particularly regarding the instalment loans based on euro currency. The level of LIBOR 3M EUR was

<sup>7</sup> *Financing a private sector recovery*, Presentation for the Parliament, Department for Business, Innovation and Skills, United Kingdom, July 2010, <http://www.bis.gov.uk/assets/biscore/corporate/docs/f/10-1081-financing-private-sector-recovery>, p. 22.

positively changing since August 2008. It reached the breakdown point in January 2010 (the lowest level was observed at 0.9313).

The credit risk for the borrower is a key element of loan pricing. Since the beginning of the financial crisis there has been made a reassessment of the creditworthiness of borrowers and of the expected risk of business loan defaults, leading to higher spreads on loans. Many banks recorded in 2007–2009 significant impairment of their loan portfolios, often involving SMEs debts. The bank's solvency ratio changed for worse as new risks for banks appeared affecting very large increase in the cost of financing for the bank. In such terms "traditional" banking has provided greater stability. Risks affecting the liquidity of companies, including SMEs, broadened and incorporated not only traditional sources of risk, but also, paradoxically, the situation at the banks. Despite high losses in the crisis, banks accumulated a significant amount of liquid assets and maintained positive levels of capital adequacy ratios. Banks implemented stricter criteria for funding, particularly for selected sectors, like SMEs. They executed much more thorough analysis of customer's finances, also addressed to the future, and looked through the entire loan portfolio. There have been assembled the behaviours of firms to which the banks were not accustomed, like hiding the facts or presenting them in a different, not real perspective.

SMEs in Poland are focusing on the trade with partners mainly from Scandinavia and Western Europe. This implicates the need for foreign exchange transactions ensuring the opportunity of the exchange of a local currency to euro, Swedish crone or Danish crone. Fig. 5 shows the volatility of the most important currency pair for Polish enterprises, which is EUR/PLN. The most dramatic rate changes were observed in 2008 and 2009, when it changed from 3.21 on 1 August 2008 to 4.89 on 18 February 2009. Consequently, SMEs in Poland suffered the rising costs of loans due to the rising level of LIBOR quoted for euro currency and the fluctuations of exchange rates, especially concerning EUR/PLN currency rate.

The matter is why the market was not able to cope with negative events. The collapse affected the majority of the markets with great dynamism being the consent of many fundamental reasons. The question has been called into the fundamental value of today's economy – confidence. An excessive increase of the financial sphere over the real sphere emerged from easy access to money and creation of financial engineering helping to liquidate unprecedented assets. The other problem was the rising importance of the short-term profit, instead of building long-term value in the enterprises.



**Figure 5.** EUR/PLN exchange rates in the period of 2006 – I quarter of 2011. *Source:* National Bank of Poland, <http://www.nbp.pl/>, 31 March 2011

There are, however, some features that saved the Polish SMEs and economy from collapse. For the companies it was the high level of exports, despite a drop in demand and unstable exchange rate for importers, then EU funds, ability to cut costs, flexibility. For the economy in Poland one of the most considerable determinants of surviving the crisis was a low degree of credit engagement in the economy comparing to the other EU countries. The improvement of the macroeconomic situation should help the SMEs position. The share of loans, that recorded deterioration, should decline leading to a general enhancement in the financial status of SMEs.

Worth a notice is that SMEs loans started to be a key asset class for portfolio managers of banks through securitization (Madar, 2006). This has been identified as an area of interest by which SMEs lending may be supported and stimulated. Despite a negative opinion about advanced securitization schemes at the level of SMEs these mechanisms are not worked out by investment banks, but by local or regional banks at the much smaller scale, meaning the volume and complexity of transactions.

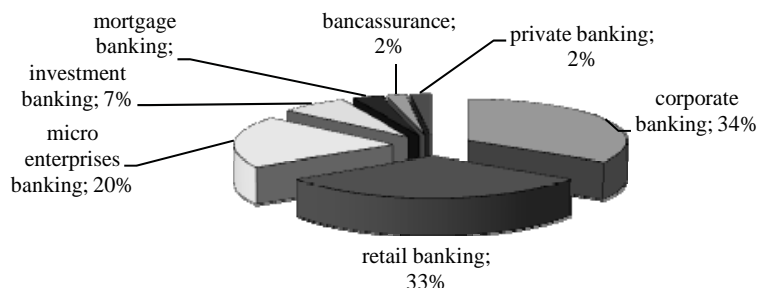
#### 4. Relations between banks and SMEs in financial crisis

During the financial crisis most of entrepreneurs noticed the rise of banking service prices as well as the introduction of stricter loan granting criteria. The main reason for tightening credit policies towards businesses was the fact that banks had not been sure of their customers' solvency. Looking from the banks' point of view, SMEs are perceived as clients of a higher level of risk. It is caused mainly by two reasons. First of all, their assets and collateral are rather weak especially while calculating creditworthiness of this group of customers. Managers working in banks find the biggest problem in: insufficient collateral (85%), lack of consumer's



creditworthiness (52%), low investment perspectives (36%) and problems in preparing good business plans (32%) (Monitor Bankowy, 2004). The second problem is the first year survivability ratio that from many years is high (the ratio remained relatively stable in the period 2001–2006 – from 61.5 to 67.6%. The significant growth of this ratio was in 2007 – 70.7% and in 2008 – 76.4%) (PARP, 2010).

Fortunately current relations are gradually improving, especially with regard to small and medium sized firms. The banks have started perceiving them in terms of entities worth collaborating with. Analyzing marketing strategies implemented by banks in Poland it must be said that some of them treat SMEs as one of the target market and are interested in selling them a package of services and products tailored to meet their needs (see Fig. 6).



**Figure 6.** Segments of the highest development potential of banks in Poland. *Source:* Monitor bankowy, Związek Banków Polskich/Pentor Research International, January 2010

In the survey conducted in January 2010 bankers said that they expected the largest expansion opportunities in cooperation with small and medium enterprises (34%) and micro businesses (20%), as opposed to previous years when the most favoured group of business partners consisted of retail, advances. In Poland, there are approximately 1.8 million micro businesses employing from one to nine persons, 55,000 small enterprises providing jobs to 10–49 workers, and slightly more than 16,000 medium-sized firms employing from 49 to 250 people (Śmiłowski, 2010). More and more banks offer a personal Account Manager who can settle any banking business and guarantee complete service. This person must perfectly know requirements of his clients and select optimal products from the bank's offer. Moreover, in future this financial advisor should suggest the most useful financial solutions to lead SMEs' activity. Moreover banks offer them *tailor-made* credit and deposit products. It suffices to take a look at communication and advertising campaigns of the banks in 2010.

This strategy seems to be very important especially because SMEs are very loyal to their banks and it is rare when they decide to change the bank once chosen (Czajkowska, 2006). Entrepreneurs are also rather satisfied with the cooperation level with banks as well as with the quality of bank services. Such opinion was expressed by 69% of respondents of micro companies, 69% of small enterprises

and 75% of medium sized companies (Śmiłowski and Idziak, 2010). Although, the owners and managers of SMEs find banking knowledge complicated and not comprehended. This opinion can be confirmed by different market researches. Majority of them (18–36%) state that their knowledge is too little, while 19–57% of them know nothing about selected outer financial products. Most of them use equity capital, commercial and preferential credits for their current activity. Leasing as well as European funds are reserved to finance their investments. Moreover, SMEs are rather sceptical about loans or subsidies. Taking out loans is associated with financial problems rather than seizing opportunities. Subsidies, at the same time, evoke associations with excessive red tape.

On the other hand it is optimistic that thanks to supporting actions concerning the development of enterprises situated in the eastern part of Poland in recent years, companies from this region have better knowledge of the opportunities offered to them by financial and state institutions (Orłowski, Pasternak, Flaht 2010).

There is a long way to creation of a bank specifically designed for SMEs. The most hopeful example of a bank intended for servicing only the small and medium enterprises is placed not in Europe or USA, but in Malaysia. The SME Bank (Bank Perusahaan Kecil & Sederhana Malaysia Berhad) is functioning since 2005 as a development financial institution to care for and meet the unique needs of small and medium enterprises. It operates as a one-stop financial centre through its head office in Kuala Lumpur and 18 domestic branches, replying to the funding and business growth requirements of Malaysian SMEs. The SME Bank supplements existing products and services obtainable in commercial banks through a wide-ranging advisory services.

## 5. Summary

To sum up these considerations, it can be clearly observed that both the banks and the SMEs have successfully adapted to the changing macroeconomic environment, however it was a tough lesson for them, especially in terms of buoyancy failure. The recovery of the domestic economy will lead to an improvement both in crediting ratio and SMEs revenues. Further impairment could be possible only in case the difficult economic development scenario will reveal in the world.

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#### **WPŁYW GLOBALNEGO KRYZYSU FINANSOWEGO NA WSPÓŁPRACĘ POMIĘDZY MSP A BANKAMI**

Sektor MSP pełni kluczową rolę w rozwoju polskiej gospodarki. Jest on często postrzegany przez banki jako obiecujący i dochodowy, ale jednocześnie dość ryzykowny. Ryzyko to wynika najczęściej z dość krótkiej obecności tych firm na rynku oraz braku dobrej jakości zabezpieczeń spłaty kredytu. Analizując sytuację różnych grup podmiotów na rynku usług finansowych można powiedzieć, iż pozycja MSP jest raczej słaba. Wynika to z wielu czynników: gorszego dostępu do informacji, niższej ich jakości oraz niższego poziomu wiedzy merytorycznej w zakresie świadczonych usług finansowych. Jednym z wielu problemów, z którymi borykają się te przedsiębiorstwa jest utrudniony dostęp do zewnętrznych źródeł finansowania. Są one niezbędne do prowadzenia bieżącej działalności, jak również umożliwiają ich dalszy rozwój. Problem ten pogłębił od 2008 roku globalny kryzys gospodarczy i finansowy, a zwłaszcza brak zaufania m.in. pomiędzy instytucjami finansowymi i podmiotami gospodarczymi. Celem artykułu jest ukazanie wpływu globalnego kryzysu na relacje pomiędzy bankami a MSP.