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Discouraged borrowers: Evidence for Eurozone SMEs

Ciarán Mac an Bhaird [a,*], Javier Sanchez Vidal [b], Brian Lucey [c]

[a] Fiontar, Dublin City University, Ireland
[b] Universidad Politécnica de Cartagena, Spain
[c] School of Business, Trinity College Dublin, Ireland

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ABSTRACT

This study examines the decision by firm owners not to apply for intermediated debt due to a perception that their application will be rejected for a sample of small firms in 9 European countries. Compared with firms that applied for bank loans, discouraged borrowers are smaller, younger, have declining turnover and an increasing debt to assets ratio. Transmission of macro effects through the banking system and the economic environment also leads to higher levels of discouragement. Higher regulatory quality results in greater borrower discouragement, indicating the importance of regulation and enforcement mechanisms for the efficient functioning of private debt markets.

1. Introduction

Efficient supply of adequate investment finance to the small firm sector is a persistent policy concern and recurring theme in the SME literature (Cole and Dietrich, 2013). One view is that there is an inadequate supply of debt finance to the SME sector (Stiglitz and Weiss, 1981), whereas the polar opposite view contends overinvestment in excess of socially efficient levels (De Meza and Webb, 1987). Whilst it is important to ensure a supply of private sector credit to encourage investment, it is equally important not to fuel the over optimistic plans of entrepreneurs (Hayward et al., 2006). Efficient allocation of funds should, therefore, seek to ensure adequate investment finance for 'good' borrowers, and deny finance to 'bad' borrowers. This should result in greater amounts of finance at a lower cost for the former, and a reduction in loan applications from the latter. A primary obstacle in avoiding under/overinvestment is information asymmetries between lender and borrower, which lead to misallocation of credit (adverse selection) and potential misuse of funds (moral hazard). Although banks employ a number of lending techniques to advance finance to informationally opaque firms, a number of SMEs continue to experience financial constraints (Artola and Genre, 2011). A frequently cited factor for the inadequate supply of finance to 'good' borrowers is the rate of loan refusals, although relatively few applications are rejected (Fraser, 2004), and these rejections may be justified as not creditworthy (Freel et al., 2012). Notwithstanding this evidence, studies continue to concentrate on the issue of loan rejection, and this is reflected in policy responses which are typically concentrated on the supply side as governments attempt to promote rates of investment.

A more significant barrier to investment, however, may be the decision of the firm owner not to apply for intermediated debt because of fear of refusal (Levenson and Willard, 2000; Cavaluzzo and Wolken, 2005). Levenson and Willard (2000), Freel et al. (2012) find that twice as many firms were discouraged from making a loan application as were rejected. In the case of uncreditworthy firms, self-selection of discouragement is not problematic as it adds to the efficient functioning

* Corresponding author. Tel.: +353 17008914.
E-mail address: ciaran.macanbhaird@dcu.ie (C. Mac an Bhaird).

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of SME finance markets. By contrast, reluctance to apply for debt by firms with good credit prospects leads to sub-optimal levels of investment. We therefore adopt Kon and Storey's (2003: 47) definition of a discouraged borrower as "...a good firm, requiring finance, that chooses not to apply to the bank because it feels its application will be rejected...". Heretofore it was difficult to investigate this subject as, unlike loan refusals, discouragement is largely unobservable. Empirical studies have been facilitated by compilation of surveys such as the Investment World Bank-EBRD Business Environment and Enterprise Performance Survey (BEEPS), the Federation of Small Business Survey (FBS), and the ECB Survey on the access to finance of SMEs (SAFE). Recent studies include Central and Eastern Europe (Popov, 2013), US (Han et al., 2009), UK (Freel et al., 2012) and underdeveloped economies (Chakravarty and Xiang, 2013).

Levels of borrower discouragement may be exacerbated by macroeconomic factors and events. In times of financial crisis, for example, borrower discouragement may be greater as increased pressures are potentially transferred through the banking system, resulting in a decreased supply of credit to SMEs (Popov, 2013). This can result in a credit crunch, at which time small businesses may be particularly vulnerable (Carbó-Valverde et al., 2009). A further issue is that discouragement in small firm owners may be increased even further in times of recession, as declining business conditions result in added liquidity pressure on SMEs. These interrelated issues have, as yet, not been empirically examined for small firms in the European Union. We address this lacuna by examining potential determinants of borrower discouragement in a number of European countries. We add to the literature in a number of ways. Firstly, we investigate potential firm characteristic determinants. We examine fundamentals such as changes in profitability, debt to assets ratio, and level of capital reserves. We add to the sparse literature on the effect of financial distress on firm owners' borrowing behavior by conducting an empirical examination of financial stress on the application decision. Secondly, we investigate the effect of macroeconomic factors on discouragement, including Gross Domestic Product, the level of financial distress in an economy, and the level of private sector credit. Thirdly, we examine the effect of regulatory and banking sector variables on levels of discouragement, specifically the quality of regulation, and the concentration of the banking sector. In a departure from the traditional supply and demand literature approach, we examine factors of (a) a difficult business environment, (b) a difficult financial environment, and (c) latent levels of discouragement simultaneously. Our study is therefore a novel investigation of subjective perceptual issues, which are likely at increased levels during periods of financial crisis. We aim to inform policy debate about intervention in SME financing markets, and whether such intervention is justifiable or needed.

2. Previous relevant literature

The burgeoning literature on SME financing focuses predominantly on issues of supply and demand for finance, commonly addressing the perennial question of whether there is adequate supply of finance to the sector. Studies can be categorized as microeconomic investigations of firm and owner characteristics of finance (Blackburn et al., 2013), and broader studies examining macroeconomic and structural issues (Djankov et al., 2007). These studies test theoretical predictions about the importance of country specific issues such as the institutional and legal environment (Beck et al., 2011), and firm characteristics (Psillaki and Daskalakis, 2009), although it is rare for both to be included in the same study. Of particular interest for researchers is firms' success rate in applications for intermediated debt from financial institutions, and determinants of success or failure (Casey and O'Toole, 2014). There has been an increase in the number of these studies in the aftermath of the financial crisis, with a particular emphasis on how demand for investment finance has changed (Cowling et al., 2012; Mac an Bhaird, 2013). In the following sections we review empirical evidence from previous literature which has a significant impact on levels of investment in small firms, and is relevant when investigating perceptual issues.

2.1. Firm characteristics and financial conditions

The principal barrier to efficiency in SME lending markets stems from information asymmetries. The optimal solution is for full information on small firms, but the primary barrier to collecting this information is that it is costly and thus inefficient for financial institutions (Baas and Schrooten, 2006). Lack of full information may result in inappropriately allocated capital (adverse selection), or agency costs (Lopez-Gracia and Mestre-Barberá, 2015). Banks employ a number of lending techniques to safeguard against potential losses, including asset-based, financial statement, credit scoring and relationship lending. A firm's capacity to fulfill lenders' requirements is dependent on availability of resources, which is determined by the profile of the firm. Firm characteristics are, therefore, an important determinant of finance (Mateev et al., 2012). In general, larger, older firms are likely to have greater reserves than younger, smaller firms (Mac an Bhaird and Lucey, 2010; Mac an Bhaird and Lynn, 2015). Additionally, older firms have established relationships with one or more banks (Freel et al., 2012), and these reputational effects result in easier access to bank debt (Diamond, 1989) because of reduced opacity over time. These borrowers are also more likely to apply for finance given past experience, as application costs (Kon and Storey, 2003) are likely to be relatively lower for this group.

A firm's external financing requirement is dependent on the availability of internal capital to finance positive net present value (NPV) investment projects. Firms with adequate financial reserves, and/or accumulating retained profits may not require external finance (Vos et al., 2007), or may be relatively confident of securing outside investment. Businesses experiencing financial distress will likely experience a much more difficult external financing environment than their