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The Financing of SMEs in Poland with Particular Reference to the Role of Banks

Thesis presented by

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Moreover, the author is most grateful for being allowed to use a database of 300 face-to-face interviews with SMEs managers in Poland, carried out by the Department of Entrepreneurship and Industrial Policy at the University of Lodz, Poland in association with the Centre for Enterprise and Economic Development Research at Middlesex University Business School, England.

Abstract

The development of a SME sector is widely recognised as being essential to overcome the problems countries face as they are transformed from centrally planned into market economies. Therefore, sustaining the growth of the private SME sector is important.

The shortage of external finance is reported to be one of the main constraints SMEs are facing and opportunities for SMEs to access credit facilities from banks and financial support programs are still limited, especially for long-term credit. The creation of an efficient working financial market in Poland therefore is a very important part in the transition to a market economy.

However, if such a financial market is to be established successfully, the needs and motivations of both small business owner-manager and banks have to be taken into account. In other words, government programmes and policies as well as support programmes by other organisations should consider these needs and motivation to contribute effectively to the development of the financial market and thus to the development of the SME sector in Poland.

The thesis aims to contribute to a better understanding of the operation of the financial market with respect to SMEs in Poland, focusing on the role of banks. This includes considering the factors influencing the demand for finance by firms, factors influencing the practices of banks with respect to supplying finance to these firms and the relationship between the two. The main findings in this respect are that owner-managers have to focus on their relationship to banks, whereas banks need to recognise the small business sector as an important fragment of the lending market, and, if they want to penetrate this market, they have to adjust their lending policies accordingly.

With regard to policy makers it appears that they need to improve their understanding of the small business sector in order to realise the effect general regulations have on small firms and in order to provide suitable support programmes to eliminate size related disadvantages experienced by SMEs. Moreover, policy makers should consider the low level of interest that currently exists among commercial banks in dealing with SME when choosing channels for their support schemes.

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1. INTRODUCTION

1.1 Aims of the thesis

The aims of the thesis are to contribute to a better understanding of the nature and extent of finance available to small and medium sized enterprises (SMEs) in Poland, the factors influencing whether or not firms are able to secure it and the types of strategies used by entrepreneurs to deal with a shortage of external finance. A key aim is to make recommendations to policy-makers, bank managers and other intermediaries (supply side of external finance) as well as to entrepreneurs (demand side of external finance) to improve the efficiency of the market for small business finance.

More specifically the objectives of the thesis may be summarised as follows:

1. To analyse the factors influencing the decisions made by Polish SME owners with regard to their sources of finance
2. To analyse the factors influencing the policies of Polish banks and bank behaviour with respect to small firms in Poland.
3. To analyse the role of the government and other organisations in relation to the supply of finance to SMEs in Poland.
4. To make recommendations to entrepreneurs, bank managers and policy-makers about the types of strategies that could be used to increase the rate of bank finance to SMEs

1.2 Aims in context

The development of a SME sector is widely recognised as being essential to overcome the problems countries face as they are transformed from centrally planned into market economies. Even in Poland, where the operation of private firms owned by individuals or partnerships was permitted during the communist period to a certain extent, the SME sector only played a minor role in the economy.[1)] Indeed, it has been suggested that this low ratio of small firms has been one of the major reasons for the inefficiency of the economy because of the lack of competition as well as the extremely high degree of concentration of the state owned firms and following this, their inflexibility and bureaucracy (Piasecki 1991).

Sustaining the growth of the private SME sector is therefore important, not only because the right of private property is indispensable in a market economy but also to correct the distortion in the firm-size-structure of the economy. In economies in transition SMEs contribute to the development of the economy by absorbing human resources which are set free by the closure or restructuring of large state owned companies. They also play an important potential role in changing export patterns, thus contributing to the international

1) About 25 percent of the labour force was employed in the private sector, mainly in agriculture (Maczynske et al 1993).

competitiveness of the economy. Another effect of SME development is the increasing number of people with a direct stake, as owners, in the economy and therefore with a vested interest in social stability (Hübner 1996).

Former surveys (OECD 1996, Smallbone et al 1996, Smallbone et al 1995, RWI 1994a, Grabowski et al 1992 and Grabowski & Kulawczuk et al 1991a) have shown that there are problems in the financing of SMEs in Poland which have a negative impact on SMEs for both business start up and development. Indeed, the shortage of external finance is reported to be one of the main constraints SMEs are facing (OECD 1996a pp 47-48, Smallbone et al 1996 pp 40-41 and Grabowski et al 1992 p 50). The opportunities for SMEs to access credit facilities from banks and financial support programs are still limited, especially for long-term credit. Therefore start-up finance is provided mainly from personal sources, investments are funded mainly from retained profits, own savings and/or mainly short-term bank loans. This undoubtedly has negative consequences for the development of SMEs, as personal sources are not sufficient and short-term credits are unsuitable for long-term investments, particularly where the income generating benefits occur only after a considerable time lag. The creation of an efficient working financial market in Poland therefore is a very important part of the transition to a market economy.

However, if such a financial market is to be established successfully, the needs and motivations of both small business owner-manager and banks have to be taken into account. Only then can one be sure, that government programmes and policies as well as support programmes by other organisations contribute effectively to the development of the financial market and thus to the development of the SME sector in Poland.

1.3 Methodology

The methodology used has four main elements which combine quantitative analysis of survey data (element II) with insights into process through qualitative methods. The latter took the form of semi-structured interviews with bank managers, small business advisers (element III) and entrepreneurs (element IV):

I. A literature based review of the factors which are relevant to an understanding of the financial needs of SMEs, the positions of the banks and the economic situation in Poland.

   This includes studies of SMEs undertaken in Poland (e.g. Smallbone et al 1996, RWI 1994a, Webster 1992), literature about the banking system and the economic and political changes in Poland as well as a review of literature that deals with the western experience of the relation between SMEs, banks and government regulations.

The aim was to summarise the already existing knowledge of factors influencing the behaviour of SMEs, banks, the government and other organisation in relation to the supply of finance to SMEs in Poland.

II. Additional and more in depth analysis of a survey of 300 face-to-face interviews with SME managers in Poland, carried out by the Department of Entrepreneurship and Industrial Policy, University of Lodz, Poland in association with the Centre for Enterprise and Economic Development Research, Middlesex University, between May and June 1995. Throughout the thesis, this study will be referred to as the "1995 study".

The database, which is one of the richest empirical databases available in Poland at present, had been analysed by Smallbone et al (1996). However, as the database had not been fully analysed with respect to the financing of SMEs, further analysis provided a more detailed picture concerning the financial constraints on SMEs in Poland. Analysis of these data focused on the following research questions

A. What are the characteristics of firms that have been successful in raising bank loans compared to those who were not successful?

B. On what terms are firms interested in raising additional finance for their business? (amount, repayment period, interest rate)

C. To what extent are firms willing to consider external equity and what are the characteristics of firms with a strong interest compared to others?

Even though data were gathered in the survey to throw some light on these questions, the analysis is limited by the fact that the survey was undertaken for a study examining the survivability and growth of SMEs in Poland and the Baltic States, rather than specifically to investigate the financial sources of SMEs in Poland. For example, question about the year in which firms tried to access external finance, the amount of collateral and the interest rates that were required by the banks were not included in the survey.

III. Key informant interviews were undertaken with four bank representatives and four small business advisers in the Lodz region, Poland, with the support of the Centre for Enterprise and Economic Development Research, London, and the Department of Entrepreneurship and Industrial Policy, University of Lodz, Poland. The main aim here was to obtain more qualitative data about the position of the banks with respect to the small business sector, as well as details from small business advisers about their experience with regard to SME finance. Therefore, interviews with the banks representatives included a discussion about their lending policy in general and their

lending policy towards SMEs in particular. Additionally, bank representative were asked to report about their experience in lending to SMEs. Small business advisers were asked questions about the service offered to SMEs and their experience in dealing with SMEs. The interview also covered the business advisers point of view with regard to the attitude of banks towards SMEs and the working relationship between bank managers and SME managers. Finally, concepts of how to improve the flow of bank finance to SMEs were discussed.

Banks were selected from those that include small firms among their clients. The bank representatives that were interviewed were all personnel that were involved in decision making with respect to credit applications by small firms. As small business departments do not exist in Polish banks, the person interviewed was either the head of the credit department or the director of the branch. In addition, small business advisers were selected from organisations that aim to develop and support the small business sector in Poland. These interviewees were either the director of the organisation or worked as a business adviser in the organisation.

Because of language problems, the interviews were arranged and undertaken with the assistance of Paweł Glodek from the Department of Entrepreneurship and Industrial Policy, University of Lodz, Poland. Pawel is a PhD Student in the field of SME financing, with whom I have co-operated through an exchange organised as part of the co-operation between CEEDR and the Department of Entrepreneurship at the University of Lodz.

All interviews were conducted by Pawel in Polish in my presence, based on a topic guide which I produced (see appendices III and IV). Pawel made detailed notes in Polish during the interviews. He also translated the main points into English in order that I could actively participate by asking follow up questions. A simultaneous translation of the interview would not have been practical, considering the fact that Pawell is not a trained translator.

After each interview, I undertook a de-briefing session with Pawel to discuss the interview in detail, which took approximately 2 hours in each case. An alternative method would have been to employ a professional translator to carry out the interviews, although resource constraints did not make this a feasible option. Moreover, the fact that a professional translator is not likely to be an expert in the subject of small business finance, and hence not familiar with the terminology used, might led to misunderstandings during the translation and therefore to inaccurate or incomplete results.

IV. Seven company case studies in the Lodz region, Poland, with the support of the Centre for Enterprise and Economic Development Research, London, and the Department of Entrepreneurship and Industrial Policy, University of Lodz, Poland.

The role of these case studies is to provide insights into the nature of the relationship between the firm and banks, based on the firm's actual experience. As a consequence, these interviews included a discussion of the firms experience in approaching bank managers for finance, together with details of the banks treatment of their application for credit

Firms were selected from the original survey (undertaken in 1995) from those that had tried to access external finance, aiming to interview both firms that were successful and unsuccessful in raising external finance. The person interviewed was the owner or a partner of the small business. The method used for the interview was the same as described for the key informant interviews and those with bank representatives (element III).

1.4 SME Characteristics and Definition

The major characteristics of SMEs which distinguishes them from large firms with regard to their sources of finance are as follows:

- SMEs have more limited financial and human resources than larger companies (Keasey et al 1993).
- Because of their size, smaller firms have more limited choices of external sources of finance. For example, larger firms have the possibility to use the stock market, whereas shares of smaller firms are not traded (Murray 1995, Ang 1991).
- The level of business failure within the SME sector is higher than in that of larger companies (Keasey et al 1993). Therefore dealing with smaller firms is more risky for providers of external finance compared with dealing with larger firms.
- In the majority of cases SMEs usually are managed and owned by the same person, in contrast to larger companies where these roles are typically split between the professional management and the shareholders. Therefore, owner-managers of SMEs are not accountable for their actions towards any third parties where as managers of larger companies have to justify their decisions in front of their share holders (Winborg 1997). In result, proceedings within larger firms are likely to be more formal, which makes it more easy for outside investors to monitor the business

activities of larger firms than those of smaller firms. Because of the fixed cost factor in adequately monitoring the business activities of firms, it is also relatively more costly for outside investors to monitor SMEs than to monitor larger companies (as the amount of business possible with larger firms is typically greater then with smaller firms).

- In SMEs the owner-manager's personal approach towards issues such as debt financing as well as his/her knowledge of sources of external finance directly influences the company's behaviour. In larger companies, on the other hand, decisions may be made in teams thus reducing the influence of single persons.
- Because of these characteristics and their lack of bargaining power SMEs often have more problems and/or higher costs than larger firms in attracting external finance, conducting negotiations and complying with (some) regulations (Scherr er al. 1993).

The situation for SMEs in Poland is further worsened because of the existing network of relationships from the centrally planned economy between managers of state firms and bank employees which can lead to the favouritism of (former) state firms by banks in the approval of credits. The lack of institutional infrastructure at regional level, the still underdeveloped competitive structure and the lack of expertise in the area of small-scale credit provision in the banking industry creates further difficulties for SMEs (OECD 1996b, Polanski 1995). It is therefore necessary to distinguish between small and large firms in Poland in respect of their financial problems, their relations to banks as well as the effects of political decisions.

During the transition period the definition of SMEs in Poland changed within the scope of re-classification of the private sector, which was influenced by West European standards. According to the main Statistical Office firms with less than 50 employees are defined as small and firms with more than 50 and less than 200 employees are defined as medium sized firms. But this is not the only definition. Other criteria were used for various reasons which can make comparison difficult (Karwowska et al 1993). The same problem occurs in western literature where different definitions are sometimes used for different surveys or for different government programmes.
In order to achieve the best possible homogeneity within the thesis, the SME definition used for the case studies was influenced by the definition used for the survey of the 300 face-to-face interviews. According to this definition, firms had to be independently owned (i.e. not part of a larger organisation), at least 50% of the ownership in private and domestic hands and employ not more than 100 employees in 1995.

1.5 Structure of the report

The rest of the thesis is divided into four main chapters, followed by conclusions and implications for policy.

The second chapter is about SMEs in transition in Poland, describing the situation of SMEs during the communist period, the growth of SMEs during the transformation period and the role of the government in relation to SME development. Changes and trends of the economic environment will be mentioned where appropriate. This is necessary to understand the current financial position of SMEs in Poland which is influenced by the former and present economic and political environment.

Chapter three reports about the availability of different sources of finance as well as the different types of finance in terms of their suitability for the financial needs of SMEs.

Chapter four is concerned with the demand side of finance, the preferences of SMEs for certain types and amounts of finance as well as strategies of firms in accessing finance or dealing with a shortage of finance. This is based on data from the survey mentioned under 1.3.II as well as the data collected from the case studies mentioned under 1.3.IV and existing literature.

Chapter five deals with the supply of finance, describing the changes in the banking system, bank policy and bank behaviour. For this, data from the key informant interviews mentioned under 1.3.III was used as well as existing literature.

Chapter six is about the interrelations between SMEs and banks, including an analysis of the key informant interviews and the case studies.

Chapter seven includes conclusions and implications for policy.

2. SMEs IN POLAND

2.1 Introduction

Chapter two reviews the development of the SME sector from World War II up to the present. Political and economic changes are mentioned as far as relevant for the private sector. This is followed by a description of the characteristics of SMEs, the current barriers to SME development and trends in policies regarding SMEs.

2.2 SME development

Exact statements about the number of small private firms during the communist period and the early years of transformation are nearly impossible. Not only did standardised definitions for small and medium sized business not exist in Poland, they also changed over the years, partly to match EU standards (RWI 1994a, Karawowska et al. 1993). It is therefore appropriate to investigate the development of the private sector instead, especially as it consisted solely of small firms during the communist period and has only slightly changed since. In 1995 and 1996, SMEs contributed to 99.9 per cent to the private sector, most of which were very small firms (Piasecki et al. 1998). Another problem is that former state firms were to be included in the private sector as soon as they are completely privatised, which in practise is often difficult to assess. National statistics might also be inaccurate due to the large number of illegal private activities, especially towards the end of the 1980s. In 1989, estimates of the so called 'shadow economy' ranged between 10 and 60 per cent of GNP (Grabowski et al. 1992, RWI 1994a, Ministry of Industry and Trade 1995). Moreover, Polish statistics were based on registered firms, many of which were not actually existing (RWI 1994a, Scase 1997). The presented data therefore should be approached with considerable caution, as it indicates more the trend of SME development in Poland then providing exact figures.

The nationalisation of larger firms, which marked the beginning of the communist era in Poland after World War II, did not affect SMEs for two to three years, during which time the private sector accounted for approximately 70 per cent of the GNP. By 1968 however, this figure had declined to less than 20 per cent of GNP, following the take over of many private co-operatives by the state as well as campaigns against private enterprise, for example the campaign against shop owners and large farmers in the early 1950s (Grabowski et al. 1992, Tamowicz et al. 1992). Even so, the operation of private firms owned by individuals or partnerships was permitted in fields such as agriculture, craft[2] (services and production), smallscale retailing, freight and passenger transport, renovation of flats and houses, certain professional services, e.g. dental surgeries and design studios, the government, following the communist doctrine, tried to minimise the number of private firms (Smallbone & Piasecki 1995). Legal, fiscal and political regulations forced

[2)] Thereby crafts were defined as "a type of economic activity, in which a craftsman -owner of the firm participated directly performing the same operations as employees hired by him" hence quiet a few small manufacturing firms existed in Poland which were relatively modern and well equipped (Smallbone et al 1995).

many entrepreneurs into bankruptcy. For example, some economic activities such as foreign trade and some transportation services were legally reserved for state firms, the maximum level of retail prices allowed to be used in the private sector was determined by the Minister of Trade and Commerce and the size of a private business was limited by law (Grabowski et al. 1992, Tamowicz et al. 1992). Moreover the whole infrastructure serving the private sector was eliminated and a system of central planning authorities established which decided the flow of goods, including credits (Chiechocinska 1992). In spite of that, the regulations regarding the private sector were periodically loosened, allowing SMEs to expand, particularly in periods of economic hardship such as during the crises in 1970 and 1976. In 1976 for example, the start up of unincorporated firms by non-residents, the so called 'Polonia firms', was permitted, although only a few were actually established until the 1980s (Maczynska & Musial 1993, Chiechocinska 1992, Grabowski et al. 1992).

Economic difficulties increased in the 1980s with agriculture and industrial subsidies presenting a heavy burden for the budget[3], resulting in both price inflation and shortages of goods (G2 Economics of Transition 1995). This led to a change in the economic strategy of the government, which introduced a new law on co-operatives in 1982 (allowing the start up of businesses independent from the state apparatus) and a law on foreign investment in 1986 (permitting incorporated firms to use foreign start up capital - Grabowski et al. 1992). As a result, the number of registered private sector firms grew from 357,142 in 1981 to 572,451 in 1988, which is described by Pisasecki & Rogut (1993) as "the initial phase of development of Entrepreneurship". Nevertheless, the administrative allocation of resources favouring the public sector still existed, making the success of a private firm more dependent on its informal relations to state-owned firms or local authorities than on management skills and marketing strategies (Tamowicz et al. 1992, Grabowski et al. 1992).

Finally in December1988 the Law on Economic Activity abolished most permits and licenses formerly needed to set up a businesses by stating that " everyone is free and allowed to undertake and carry out economic activity on equal rights" (Piasecki 1992). Thus, for the first time since 1947, private businesses were treated equally to state-owned firms which led, in combination with political and economic changes, to "a period of explosion of Entrepreneurship" (Pisasecki & Rogut 1993) between 1989 and 1991 as illustrated in Table 2.1. In 1989, the 1.7 million people employed in the non-agricultural private sector constituted approximately 10 per cent of all labour in Poland (Grabowski et al. 1992).

[3]) The Polish budget deficit reached 10 per cent in 1989 (G2 Economics of Transition 1995).

Table 2.1: Changes in the private sector in 1976-1991

	1976	1980	1985	1989	1990	1991
Incorporated firms						
no of employees	-	-	-	134,718	306,240	•
no of firms	-	-	-	11,807	29,650	45,077
Polonia firms						
no of employees	-	1,506	54,231	100,240	83,230	•
no of firms	3*	46	682	847	862	787
Joint- Ventures						
no of employees	-	-	-	29,902	88,070	•
no of firms	-	-	-	416	1,645	4,796
Unincorporated firms						
no of employees	•	620,400	869,300	1,515,300	1,915,462	2,591,071
no of firms	250,000	357,000	418,000	845,677	1,135,500	1,420,000
Total number of firms	250,000	357,046	418,682	858,747	1,167,657	1,470,660

* in 1977
• non available
Note: This refers to registered enterprises.
Source: Grabowski et al. (1992)

The most significant political change took place in 1989, when the first non-communist government since 1947 was elected, legally ending the existence of Poland as a communist state by declaring a democratic state of law (Wedlawowiz 1996). In order to transfer Poland's economy into a market-base system, a comprehensive economic reform (the Balcoerowicz Plan) was launched on the first of January 1990. The plan, which was strongly influenced by the IMF stabilisation and liberalisation programme, included the following measures:

Liberalisation measures:

- abolition of the administrative supply allocation system
- deregulation of domestic and foreign trade
- liberalisation of most prices
- restructuring and commercialising of the financial sector

Stabilisation measures:

- reduction of most subsidies for state-owned enterprises
- freezing of salaries in the state sector
- positive real interest rates
- internal convertibility of the Zloty, devaluation and a stable exchange rate

(Grabowski & Kulawczuk 1991a, Gomulka 1992, G2 Economies of Transition 1995)

As a result of the reform programme prices rose by 80 per cent in January 1990 (in comparison with December 1989), the industrial output declined by about 30.4 per cent between January and June 1990 and unemployment rose by about 0.5 million persons. Between January and September 1990 the purchasing power of the society declined by approximately 28 per cent (G2 Economics of Transition 1995, Piasecki

1991). The effect of these economic factors on the development of SMEs was mixed. While the total number of SMEs increased rapidly, almost 60 per cent of new start ups between January and August 1990 were established in commerce, where as the number of production and service firms actually declined. The start of the small privatisation programme (i.e. the start-up of new small enterprises or the development of existing ones by purchasing, hiring or leasing state-owned co-operative or communal property) contributed to the increase of small retail firms as 12,000 formerly state-owned shops were transformed into private ownership in the first half year of 1990. Moreover, the deregulation of foreign trade created profitable opportunities in dealing with cheap imports. The decrease of production and service firms, on the other hand, occurred mainly because of high rents, high production costs, lack of demand for goods and services as well as due to mismanagement of owners who could not adapt to the new conditions of a market economy (Piasecki 1991). Under communism, selling was not a problem for small firms as they supplied mainly state-firms and sometimes even received the raw materials needed from the state. In the new market environment however, with collapsing state firms and the closure of the CMEA trade, firms had to search for customers and suppliers which required knowledge and management skills that were neither needed nor developed under communism (Karwowska & Mrozinska 1993, Smallbone & Piasecki 1995).

In 1991, further decreases in consumer purchasing power, increased competition and rising tax and interest rates led to a "slowing down in the rate of development of the SME sector" (Pisasecki & Rogut 1993) with even negative rates in 1995 (Table 2.2). However, a favourable economic climate in the years 1994-1996 with a real growth rate of GDP between 5-7 per cent annually and a steady reduction of the inflation rate (from 29.4 per cent in 1994 to 18.5 per cent in 1996) led to an overall increase in the number of private firms by 33 per cent between 1992 and 1996 (Piasecki et al. 1998, European Bank for Reconstruction and Development 1998).

Table 2.2: Changes in the private sector in 1992-1996

	1992	1993*	1994	1995	1996
Growth rate	+18%	+4%	+23%	-9%	+14%
Total number of firms	1,739,091	1,812,446	2,230,701	2,031,907	2,311,988

* end of June 1993
Note: This refers to registered enterprises.
Source: Piasecki et al. 1998

In 1996, 2,310,087 firms employing up to 250 persons were registered in Poland, accounting for 99.9 per cent of the private sector, which again contributed to 97 per cent of all economic units. These relations between the SME, the private and the public sector are similar to those in the UK as well as in other EU countries (Piasecki et al. 1998).

Between 1990 and 1995 the Polish private sector increased its share in total work force from about 49 per cent to over 60 per cent and nearly doubled its contribution to the GDP (from 30.9 per cent to 58 per cent in current prices) (U.S. Agency for International Development 1997). At the same time it should be noted that

the per capita GDP according to the purchasing power parity in Poland is at a relatively low level, about 3.5 times lower than in the UK and almost 4 times lower then in Germany (Piasecki et al. 1998).

2.3 Characteristics of SMEs

Following the recent development of the SME sector in Poland it is not surprising that, according to the register of the Central Statistical Office and the Ministry of Finance, the vast majority of SMEs in 1995 were fairly young firms: 63 per cent were established after 1990, 35 per cent started between 1970 and 1990 and only two per cent were more than 24 years old (The Delegation of Poland 1996). The relatively short period of trading of SMEs that is typical and the fact that the development of a private sector requires time is reflected in the size structure of the sector. In 1996, the average size of a private firm in Poland was 2.5 employees, compared with 5.4 employees in the UK and 8.5 employees in Germany. At the same time, as illustrated in Table 2.3, the overall structure of the private sector in Poland indicates a general deficit in the development of medium sized firms. As the setting up of medium-sized firms tends to be the exception, this gap can only be closed if a large number of existing small firms are successful in the market and are willing and able to grow into medium-sized firms (OECD 1996a).

Table 2.3: The size structure of the private sector in 1996

	Poland		UK		Germany	
Firm size in no of employees	share in private sector	average no of employee	share in private sector	average no of employee	share in private sector	average no of employee
up to 50[1)]	99.46 %	1.6	99.1 %	2.6	98.1 %	3.7
51-249 [2)]	0.46 %	100.5	0.7 %	93.1	1.5 %	78.9
over 249	0.08 %	513.0	0.2 %	1,113.3	0.4 %	909.1
Total number of private firms [3)]	2,311,988		3,760,000		3,440,000	

[1)] In the UK and Germany this figure relates to firms with up to 49 employees
[2)] In the UK and Germany this figure relates to firms with 50-249 employees
[3)] This refers to registered enterprises.
Source: Statistical appendix in Piasecki et al. 1998

The growth of small businesses is also desirable because of their potential to create jobs. In other words their possible contribution to reducing unemployment rates makes growing small firms of interest to public policy makers (Storey 1994). As Polish entrepreneurs are reported to be highly growth orientated (see section 3.3.1), the question of whether or not they are actually growing is more related to their ability to grow, (hence to the ability of the owner-manager to survive in a market economy) and to barriers outside the business (such as legal and financial barriers as well as the to level of competition in the market and the macroeconomic conditions). According to a comparison of eighteen empirical studies undertaken by Storey (1994), business growth is positively influenced by the number of founders (firms with more then one owner are more likely to grow), motivation (for example entrepreneurs that are desire to make more money are more likely to want their business to grow fast than those business owner that just want to earn a living) and the educational qualification of the owner-manager.

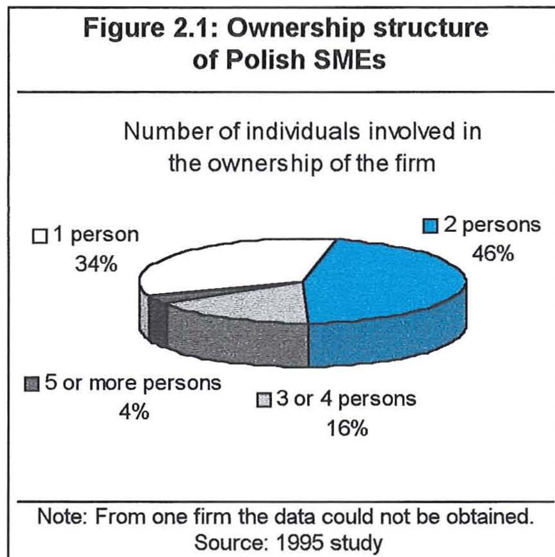


Figure 2.1: Ownership structure of Polish SMEs

Note: From one firm the data could not be obtained.
Source: 1995 study

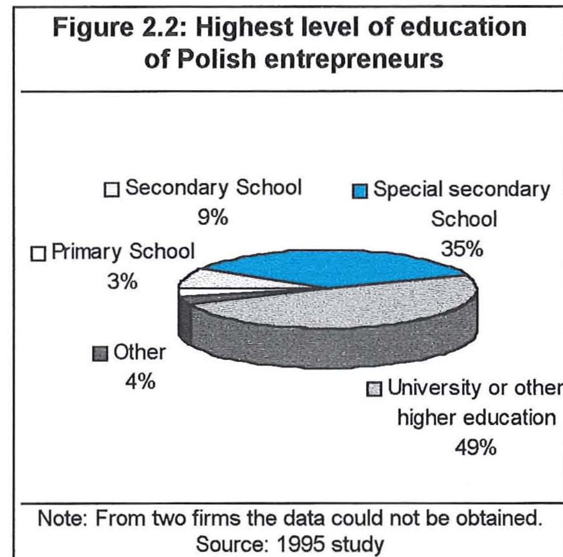


Figure 2.2: Highest level of education of Polish entrepreneurs

Note: From two firms the data could not be obtained.
Source: 1995 study

In this respect it is encouraging that, according to the 1995 survey, the majority of Polish firms seem to be owned by two or more individuals (Figure 2.1). Furthermore, the level of education among Polish entrepreneurs is reported to be high (Figure 2.2), even higher than in more mature market economies (Smallbone et al 1996). This is supported by a representative survey of Polish SMEs in 1995 undertaken by the Faculty of Economic Science at the University of Warsaw, which reports that 51 per cent of owners had higher education (Kubik et al. 1997). Another survey by Erutku & Vallee (1997) notes that 65 per cent of a surveyed sample of 48 SMEs completed their college education, which suggests that entrepreneurs are more educated than the Polish population in general (it is estimated that only one-third of Poles stay in school until age 18 and that fewer than 10 per cent go to university - Erutku et al 1997). Likewise, Polish entrepreneurs tend to be more educated than their American counterparts, as a study undertaken by the NFIB foundation in America states that 58 per cent of American firm owner had attended college. However, the higher education level of entrepreneurs should not be overestimated, as those American entrepreneurs who did have higher formal education had taken more courses than their Polish counterparts. Moreover, formal education is typically the only form of education available for Polish entrepreneurs, whereas American business owners have the opportunity to receive some vocational or professional training before setting up their company (Erutku & Vallee 1997).

Regarding the motivation of business owners for setting up their firm, it appears from the 1995 study that the majority (60 per cent) mentioned the desire to improve their standard of living or to increase their income as one of their main reasons. However, as shown in Table 2.4, the aim "to seek independence / autonomy" is mentioned even more often, which can be a reason for the owner not expand the business beyond a certain size (see section 4.2.1 for more details).

Table 2.4: Main reasons for starting the business

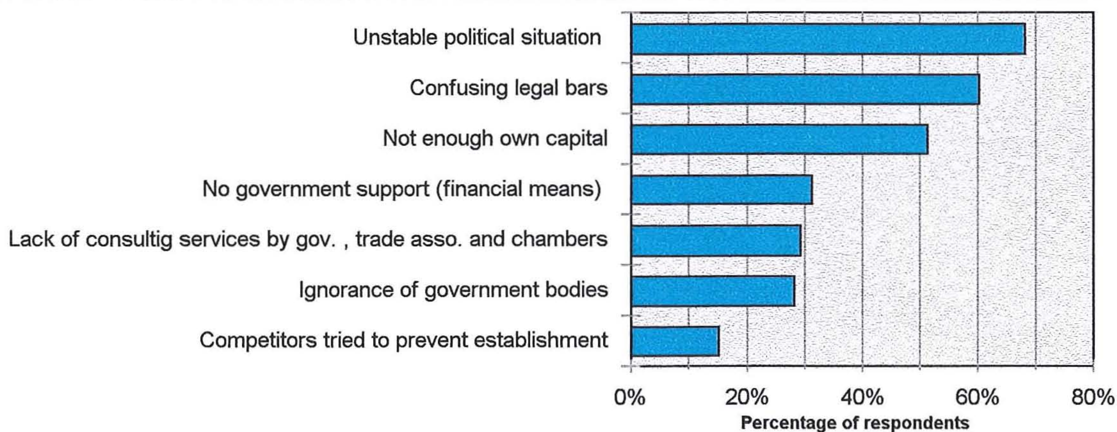
Reason	No of firms	Percentages
To seek independence / autonomy	209	70
To improve living standard / increase income	178	60
To gain self-fulfilment	153	51
Family tradition	52	17
An alternative to unemployment	31	10
Other	31	10

Note: Manager could give up to three reasons. From one firm the data could not be obtained.
Source: 1995 study

2.4 Barriers to SME development

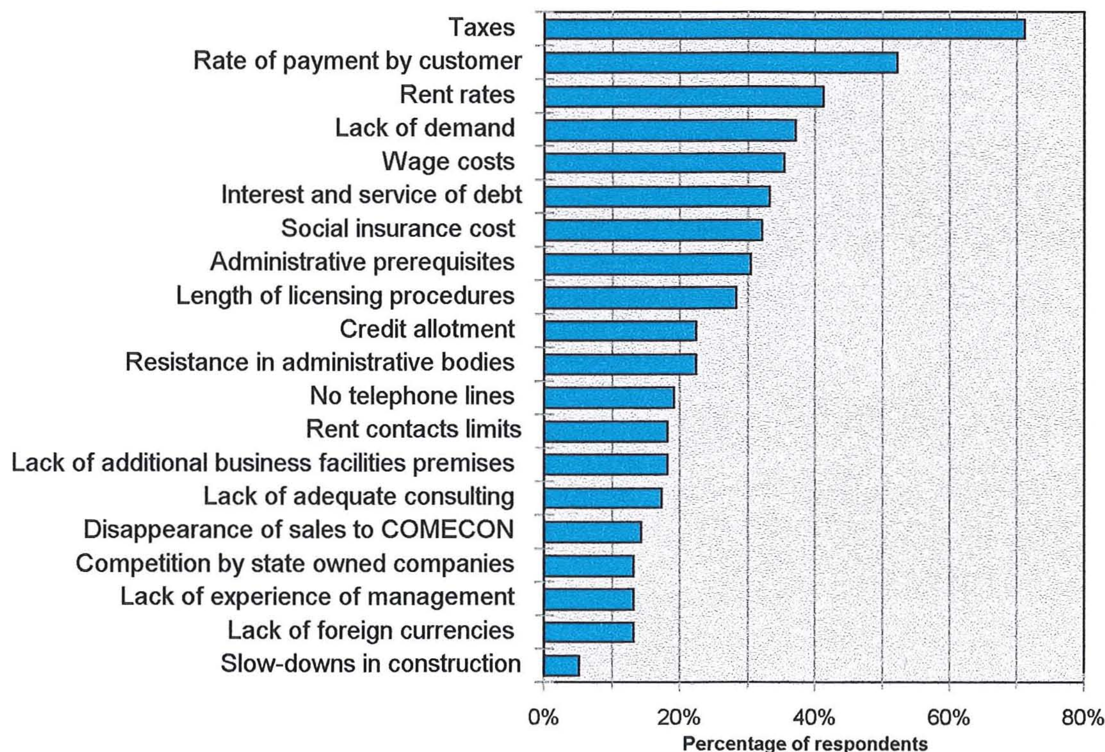
Although the barriers to SME development cited by small business owners changed over the years, reflecting the alterations in their economic and political environment, financial problems remained one of the main hindrances. A survey of 93 Polish manufacturing SMEs carried out by Webster (1992) in May 1991 reports that lack of demand was mentioned by 30 per cent of surveyed businesses as the main constraint, which is not surprising considering the decline in the purchasing power of the Polish people in the early years of transformation. Indeed, 84 per cent of firms citing lack of demand for their product as main problem believed that this was caused by a shortage of money among Polish people. However, this can also reflect weak market orientation of the businesses, as research in the UK has shown (Smallbone 1990). Financial problems ranked second, mentioned by 28 per cent of Polish owner-managers as their main constraint, of which more then half reported high interest rates to be the cause for this. The frequent change of government regulations was viewed by ten per cent of firms as a main constraint for their business activity. Two years later a survey undertaken by the Rheinisch-Westfälisches Institut für Wirtschaftsforschung revealed that the lack of capital is not so much a problem for established firms (only 22 per cent complained about credit allocation), however that it is one of the major difficulties during the start up phase (Figure 2.3 and 2.4). Nevertheless, a third of firms mentioned interest rates and the servicing of debt as a current problem, which indicates difficulties related with external finance.

Figure 2.3: Problems with the Establishment of new Enterprises



Source: Welter 1994

Figure 2.4: Current problems of Entrepreneurs

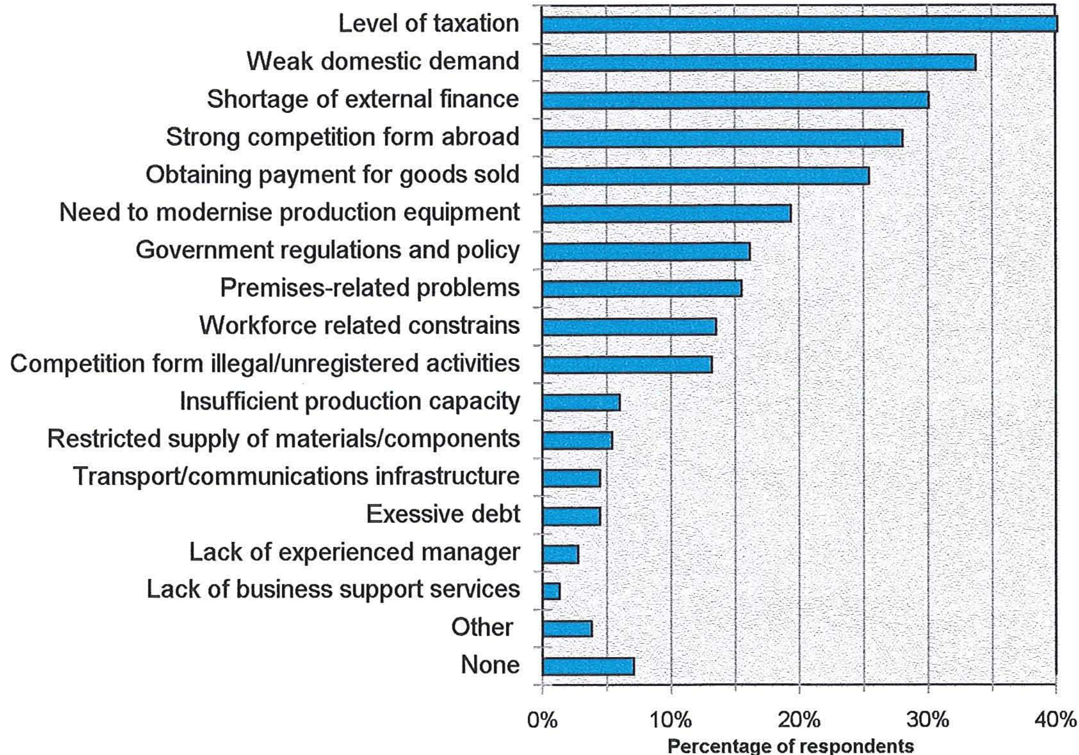


Source: Welter 1994

In the 1995 study the picture changed as 30 per cent of surveyed firms complained about a shortage of external finance, which ranked third after complaints about the level of taxation (40 per cent) and the weak domestic demand (33.7 per cent) (Figure 2.5). This might indicate that compared with the early years of transformation, it became more difficult for small businesses to access external finance. However, comparisons with the RWI study have to be treated with caution, as this survey included several sectors,

whereas in the 1995 study only manufacturing SMEs were interviewed, who have a greater demand for capital than for example firms in the retail sector.

Figure 2.5: Managers Perception of the main Constraint on Business Development



Note: Managers could give up to three main constrains
Source: 1995 survey

A more recent study undertaken by Smallbone et al. (1997) investigated the barriers to increasing sales in domestic as well as foreign markets for SMEs in the food and clothing industries. The "lack of finance to support marketing" was ranked second as a constraint in the domestic market (with half of surveyed firms mentioning this as a main barrier), after "problems with delayed payments" (58 per cent) and before "strength of competition from abroad" (42 per cent). Delayed payments can hinder the development of firms by causing cash flow problems. This is a particular problem for smaller firms, as they typically rely upon fewer customers and/or suppliers than larger firms (Keasey & Watson 1993). Therefore, in the case of small firms, delayed payments from large customers can even cause the demise of a business. Moreover, in the case of the bankruptcy of the customer, smaller firms are less likely to recover any money than larger firms, due to their lack of bargaining power. The lack of finance to undertake necessary marketing efforts also negatively influence the development of firms in a market economy where the survival of the firm depends on their ability to compete against domestic and, as mentioned above, foreign companies. With respect to exports financial problems were considered to be even more constraining, mentioned by 53 per cent of firms, followed by "domestic taxation" and "lack of information about foreign markets" (43 per cent and 28 per cent respectively - Smallbone et al. 1997). In other words, possible business development beyond the

borders of Poland might be missed out on because of the lack of financial resources. This again might be caused, among others, by the high level of domestic taxation on Polish small firms. High social taxes, for example, are a particular burden for smaller firms, because their are typically more labour intensive than larger firms (Smallbone et al. 1996).

2.5 SME policy

Until 1995, the Polish government based their economic policy on the neo-liberal doctrine which considers state intervention in the market process as not appropriate. "For the start-up period the freedom of economic activity was the basic stimulus. On the side of the government, refraining from any action was a conducive factor. The rapid growth phase then required first of all macroeconomic stabilisation" (Deputy Minister of Industry and Trade - Hübner 1996). This in combination with the reluctance of Polish entrepreneurs to co-operate with the authorities because of their view of government inherited from the socialist period resulted in the absence of any comprehensive support programme for SMEs in the first five years of transition (Smallbone & Piasecki 1995). Only a small number of reports and statements of support for SMEs were produced these years, such as the "Programme assumptions of activities of the Government Plenipotentiary for support of Entrepreneurship in the filed of SMEs development" in November 1990 (Piasecki et al. 1998), the report "Investing in the Future" prepared by the Task Force for SMEs in 1993 (Smallbone & Piasecki 1995) and the "Programme proposals supporting SMEs" submitted by the Ministry of Industry and Trade in 1994 (Pisasecki et al. 1998). Although none of the proposals were followed by real actions (Smallbone & Piasecki 1995), various SME support organisations were established on a regional level during this period, such as incubators, business support centres and innovation and technology centres. Many of these organisations were established through alliances including local businesses, community leaders and authorities and most of them were supported by foreign and international organisations. Most widely represented were the Regional Development Agencies (RDAs), most of which were set up by a consortium of community governments, agencies, banks and other actors. In the beginning of 1996, 61 RDAs existed, 47 of regional and 14 of local character (OECD 1997).

The policy of the government as outlined above and the fact the regional authorities in Poland were not representatives of regional interests but responsible for executing legislation initiated by the central government meant that regional support initially was also rather weak. The structure of the national income contributed to the problem, as the majority of funds were administered by central government (OECD 1997). In other words, the expenditures made by regional authorities had to be approved by the government, which meant that even if support was granted on a regional level, the decision whether or not the necessary funds were made available was done by the central authorities. Therefore, changes in the policy of the central government were bound to affect regional organisations immediately, as experienced by one of the key informants form the Lodz Region Economic Redevelopment Foundation. The foundation was established by the local government in 1993 with the aim of financing regional development. Even though

sufficient funds were available to the Foundation in the beginning, the budget was reduced drastically when political conditions changed, forcing the foundation to adjust their operations accordingly.

The absence of government policy also led to a lack of co-ordination not only between the various support organisations but also among ministers due to conflicts over competencies. Further complications resulted from frequent inter-ministerial changes in the responsibility for the SME sector (OECD 1996a). Moreover, the distribution of support programmes was not regulated which resulted in foreign organisations being over represented in certain areas while lacking in others (OECD 1997). However, becoming more aware of the importance of SMEs in the progress of transformation and the need to co-ordinate SME support, the Polish government established the Polish Agency for Regional Development (PARD) in 1993, both to co-ordinate action for regional development in six regions with were designated for *Programme for Structural Development in Selected Regions in Poland (STRUDER)* (see chapter 3.4.2.1. for further details) and to reinforce the emerging private-public partnerships in the regions. At present PARD continues to support regional interests and aims to mediate between the communities and the central government (OECD 1997).

Poland's desire to enter into the European Community has also formed an important incentive for the Polish Government to develop a comprehensive SME policy. "The development of a Government policy towards SMEs has become necessary, also in the light of Poland's admission to the European Community, especially when there is a possibility of including Polish enterprises in EC programs"(Ministry of Industry and Trade 1995). "The Policy towards small and medium-sized enterprises" a document presented by the Ministry of Industry and Trade, was approved by the Council of Ministers on 6 June 1995. The aim was to create political, legal and economic conditions for the development of the SME sector by applying legal, financial, organisational and information and training instruments (The Delegation of Poland 1996, Ministry of Industry and Trade 1995).

The policy programme concentrated on four key areas by intending to create favourable conditions to:

- facilitate the establishment and development of SMEs,
- decrease the risk of conducting business activity,
- increase the competitiveness of SMEs and
- develop the market of financial services for SMEs

(Ministry of Industry and Trade 1995)

The policy intended among others to improve the accessibility for SMEs to financial sources, including legal regulations to stimulate the development of local guarantee and credit funds. This included the further development of the system of credit guarantees for SMEs on the basis of the credit guarantee fund established in the Bank of the National Economy (Bank Gospodarstwa Krajowego) in 1994 (see section 6.4 for further details) as well as the development of a credit re-guarantee system for local institutions granting guarantees for SMEs. These local institutions typically have limited assets to be able to issue guarantees for credits. By creating a re-guarantee fund which shares the risk undertaken by the local guarantee funds, their

capacity to issue further credits guarantees improves, which in turn would increase the accessibility to external finance for SMEs (Ministry of Industry and Trade 1995).
The Ministry of Industry and Trade took upon the responsibility for SME development and policy, whereas the Polish Foundation for the Promotion and Development of Small and Medium Sized Enterprises had been established by the government to ensure the practical implementation and co-ordination of activities and programmes in this area. One of the objectives of Foundation was to ensure the efficient use of foreign assistance funds allocated to support SMEs (Hübner 1996, Gurbiel 1996, Ministry of Industry and Trade 1995). The policy programme was planned to be funded of "resources of enterprises in mutual guarantee funds established by the organisations of territorial self government and other local institutions which support SMEs", resources from the budget and external resources (Ministry of Industry and Trade 1995). The resources form the budget, estimated at 90m ZLP for the period 1995-97, were primarily allocated to the planned credit guarantee fund. In terms of external assistance, the main stake was awarded by the European Union's PHARE programmes, assigning up to 400 million ECU between 1995 and 1996 for technical assistance and development projects (Ministry of Industry and Trade 1995, OECD 1997).

The financing of the policy programme proved to be problematic. According to the OECD (1997) foreign donor agencies typically are more interested in investing in single infrastructural projects with presentable results rather than allocating funds to local loan guarantee funds. Moreover, as pointed out by Piasecki et al. (1998), because of the structure of the finances, the Ministry of Industry and Trade, even though responsible for the implementation of the policy, did not have complete control of the use of the funds. Another problem occurred in assessing the policy implementations, mainly because of the lack of appropriate reporting systems and the fact the majority of instruments were directed towards all economic units and not to SMEs only (Piasecki et al. 1998). However, the policy programme certainly is a step in the right towards the development of the SME sector. Nevertheless, as mentioned by the Commission dealing with Poland's assignment to the European Community, some problems concerning co-operation between the ministers and the structures involved in this policy continue to appear. Solutions are still necessary to simplify the legislation and to increase the efficiency of legal regulations (Piasecki et al. 1998).

Chambers of Commerce and Business associations, who could further represent the interests of SMEs to the government, have only limited influence for a number of reasons. The current Chamber systems consists of agricultural, industrial, foreign trade and craft Chambers, with the National Chamber of Commerce (KIG) acting as umbrella organisation (OECD 1996a). The structure used to build this system dates back to the 1970s, when Polish craft enterprises were organised in guilds, chambers and umbrella organisations (German model - Welter 1994). During the communist period the compulsory membership of the Chambers was used to support the Soviet system, thus to simplify state control in businesses. After 1989, membership of the Chambers became voluntary for businesses, many of whom decided to withdraw. This in result weakened the financial basis of the Chambers, which is why many of them operate only over a limited regional range, mainly concentrating on larger cities (OECD 1996a).

Business associations, on the other hand, are not as low valued by Polish entrepreneurs as Chambers of Commerce. Following the political liberalisation in the late 1980s, an estimated 4,000 business organisations have been established (OECD 1997). However, the diversify of these associations means that they do not have the power to represent the interests of the business sector vis-à-vis the state. So far, efforts to organise these associations in a wider, national structure, have been limited (OECD 1996a, OECD 1997).

Another problem for small business owner to be represented by either Chambers of Commerce or business associations lies in the fact that both of these organisations represent large as well as small, state-owned as well as private companies. As large firms typically have greater negotiation power, the interests of SMEs are only treated as secondary (OECD 1996a).

2.6 Key points in chapter 2

- The Polish private sector consists nearly exclusively of firms employing up to 250 persons.
- Between 1990 and 1995, the Polish private sector increased its share in total work force from about 49 per cent to over 60 per cent and its contribution to the GDP from 30.9 per cent to 58 per cent.
- In 1996, the relations between the private and the public sector in Poland were similar to those in the UK and other EU countries.
- When comparing with the UK and Germany, the overall structure of the private sector in Poland indicates a general deficit of medium sized firms, employing between 51 and 249 persons.
- The level of education of Polish entrepreneurs is reported to be higher that in some of the more mature market economies.
- Financial problems are reported to be one of the main hindrances in the development of Polish SMEs.
- The Polish government launched their first comprehensive SME policy program in 1995, partly because of Poland's desire to enter the European Community, thus it remains underdeveloped.
- Chambers of Commerce and business associations, which could represent SMEs to the government, have only limited influence and are mainly dominated by larger firms.

3. SOURCES OF FINANCE FOR SMEs

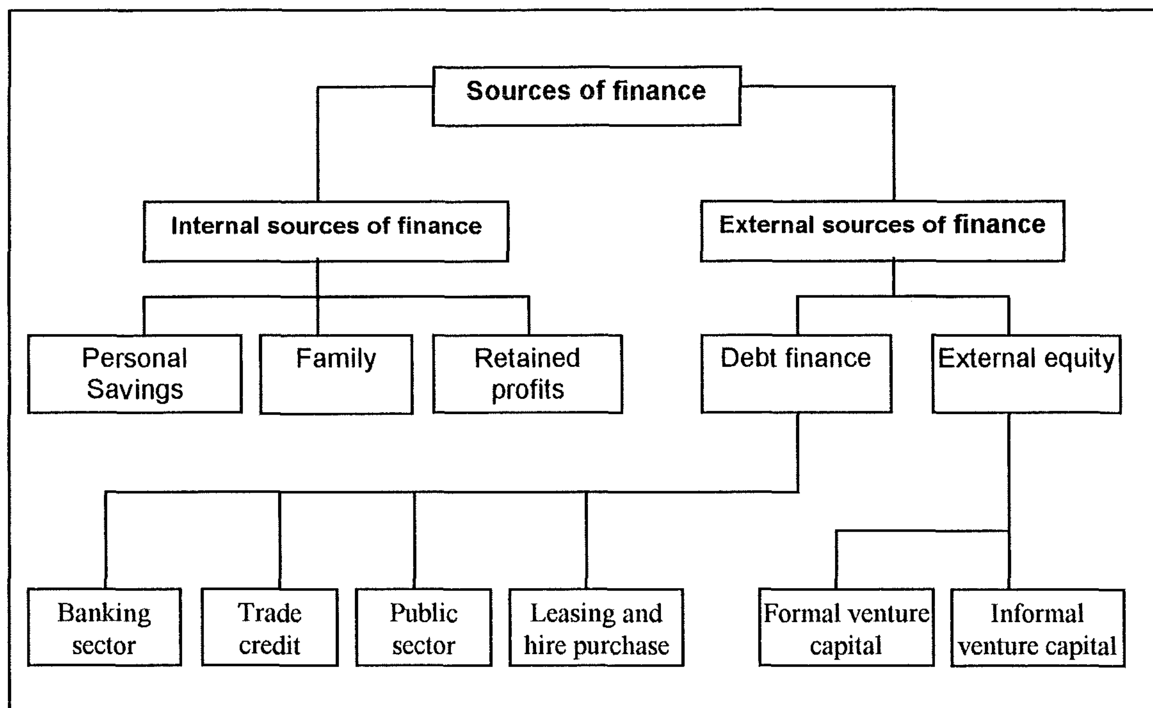
3.1 Introduction

Chapter three reports on the availability of different sources of finance as well as the different types of finance in terms of their suitability for the financial needs of SMEs.

3.2 Available sources of finance for SMEs

Possible source of finance for SMEs consist of internal as well as external sources as outlined in figure 3.1.

Figure 3.1: Sources of finance



Source: Ang 1991, Bain 1992, Binks & Ennew 1996

In this respect it is important to understand that different types of finance are needed for different purposes. In other words, the sole availability of financial means does necessarily satisfy the financial needs of a firm. The permanent capital of the business (i.e. funds needed for the start-up or expansion of the firm) needs to be financed with funds that are secured on a permanent or at least long-term bases, as the continued availability of this capital is essential for the firm's existence. Personal and external equity are suitable for this purpose as well as long-term loan finance and mortgages. In the case of existing firms, retained profits are another possible source of permanent capital. For the financing of a specific investment (i.e. the purchase of machinery, premises or vehicles) medium-term finance is needed, which secures the funds for the period of time necessary. Medium-term loans are suitable for this purpose as well as leasing or hire purchase agreements. Other financial needs occur such as working capital to finance the time lags between payments due to suppliers and incoming funds from customers as well as seasonal fluctuations in profits.

Best suited for these needs are short term loans and overdraft facilities supplied by banks as well as trade credits (Bain 1992).

3.3 Sources of finance in the communist period

Under communism, the authorities tolerated private SMEs only to a certain extent and in line with that destroyed the whole infrastructure catering for the private sector such as banks and credit institutions, specialised service firms and self-government bodies and chambers of trade and industry. (Ciechoconska 1992, Grabowski et al. 1992) Financial institutions such as banks did exist, but they did not act as financial intermediaries between savers and borrowers. Instead, they were responsible for the profit transfer of the state companies to the government (Monobank and special banks) or the transfer of private household deposits to the government (Sparbanks). Decisions on the volume and structure of credits were taken outside the banking system by the central planning authorities (Polanski 1995).

It is therefore not surprising that financing by bank loans was rare and usually short-term. Funds for the operation of the few existing SMEs came from the personal resources of owners or their relatives, in other words internal sources, or from resources raised through personal (informal) networks. It was also usual for SMEs to be in debt to other enterprises (trade credit), to receive advanced payment from the customer, normally local authorities or state companies, to delay fiscal payments or social security payments and expenses for employees (Grabowski & Kulawczuk 1991a). In the 1980s the step-by-step removal of legal barriers made it possible for SMEs or potential entrepreneurs to access financial sources in western market economies, i.e. to obtain foreign-exchange credits for purchases of machinery and materials for their export production (Piasecki 1991). Furthermore the gradual liberalisation of the passport, foreign exchange and customs policy made it possible for numerous Polish people to work (illegally) for western firms, to accumulate savings in hard currency and to transfer them to Poland to fund or to set up their own small business in Poland (Piasecki 1991, Smallbone et al 1995).

3.4 Sources of finance since 1989

After the liberalisation of the banking system and the adoption of market-type banking laws in 1989, banks became a more accessible source for external finance for SMEs, especially in the earlier years of transformation. A survey undertaken by Webster (1992) of 93 Polish manufacturing firms in 1991 notes that 68 per cent of entrepreneurs had received bank loan between 1988 and 1991. However, since then the banks became more reluctant to lend to SMEs for various reasons, as outlined in chapter five.

The development of an institutional infrastructure for SMEs by the government, as outlined in chapter two, had not been a priority in the early stage of transition. However, by now various institutions, both non-profit and commercial organisations exist to offer assistance to SMEs. The current focus of these measures lies in assistance in accessing financial sources, which only exist because of the availability of international

monetary aid (e.g. Phare). Moreover, some of them have been proved to be unsuitable for SMEs (see section 3.4.2). Certain programmes are designed for large investment projects whereas SMEs tend to be hesitant towards long-term investments because of the unstable economic situation, their lack of experience with long-term investments as well as the tendency of SMEs to focus on nominal interest rates which are likely to be very high in times of high inflation. Other programmes are too bureaucratic and too time consuming in the loan application because of the amount of banks involved (RWI 1994b, OECD 1996a).

In the section below potential internal and external sources of finance for SMEs are described and discussed in terms of their suitability for different funding purposes.

3.4.1 Internal sources

Savings from the owner or his/her family are reported to be the main sources of finance for start ups in Poland[4] (Smallbone et al. 1996, RWI 1994a, The Delegation of Poland 1996). This pattern of finance is typical for SMEs in general, in the UK and elsewhere and is partly explained by the reluctance of many SME owners towards external finance, due to the costs involved and the fear of the owner of losing control over the business (Stanworth & Gray 1991). On the other hand, some firms that are interested in raising external finance might find it difficult in doing so, for example, in the case of debt finance, because they are unable to meet the criteria banks use in their lending decision or, with regard to external equity, because of the lack of a public market for SME shares. It therefore seems reasonable to ague that the actual financial structure of SMEs may be a result of the behaviour of both the firms and the banks as well as of the infrastructure provided.

However, it appears that SMEs in Poland have to rely to a greater extent on personal savings, capital from family and other personal (informal) networks than their counterpart in more developed market economies, as SMEs in Poland almost entirely have to rely on these kind of financial sources. In the 1995 survey, 93 per cent of firms named personal savings as one of the main three sources of finance during the start up period (for 80 per cent, it was the main source), followed by capital from previous enterprises and bank finance (both mentioned by 20 per cent of respondents). However only 4 per cent of surveyed firms mentioned bank finance as their main source of start up finance. These findings are supported by a study of 143 SMEs in Poland carried out by the Rheinisch-Westfälisches Institut für Wirtschaftsforschung (RWI) in 1993/94 which notes that the vast majority of start ups (about 90 per cent) are financed through internal sources, personal savings and capital from friends and family (RWI 1994a). In comparison, small firms in more mature market economies supplement their internal sources with bank overdrafts, loans and trade credit. A survey of new manufacturing firms in the UK by Mason in 1989 noted that apart from personal savings, capital from family and friends and previous business, a mortgage or second mortgage on the founders home was one of the most important sources of start up finance (Stanworth & Gray 1991). Another

[4] Also includes "friends" in a few cases.

study of start-up finance using a nation-wide sample of UK bank data in the early 1990s reported that about 44 per cent of SMEs used bank finance to commence their business (Cressy 1993).

As the owner's personal sources of capital are likely to be used up completely (or to a great extent) for the start up expenses of the business, the owner has to use (if possible) retained profits and/or other, additional sources of finance for the necessary working capital, further investments or expansion of the firm. However, in 1993-1994 Polish SME owners relied mainly on internally generated finance for investments, namely retained profits and personal savings, which typically accounted for 50 per cent and 20 per cent (median)[5] respectively of the total amount invested during that period. Bank loans were used only to a small extent. In just 53 firms (20 per cent) reported banks as a source of finance for investment, however in these cases the loan typically accounted for about 40% (median) of the total investment (Smallbone et al. 1996). By comparison, a study by Mason in 1989 noted that in the UK the financial sources of SMEs after start up are equal proportioned on internally generated finance (namely retained profits) and external finance such as bank loans, financing houses and bank overdrafts (Stanworth & Gray 1991). Another survey by Keasey and Watson (1986-1990)[6] notes that bank debt represents in the region of 31 per cent of business liabilities and in that sense was as important as internal equity as a source of funds to small businesses. According to Cressy (1993) about 50 per cent of mature SMEs borrow at some stage from their bank. It therefore appears that whereas small firms in the UK make increasing use of external sources of finance after their start up period, Polish SMEs still rely to a much greater extent on internal sources, even when they become established.

The strong reliance on internal sources of finance of both start ups and investments can lead to serious financial problems for firms with negative consequences for the development of the SME sector. This can be the case, for example, if internal funds are insufficient to finance the gap between being paid by debtors and paying suppliers or to invest in machinery and equipment which might be necessary to compete in the market. Indeed, even in the UK, where small firms can access external finance more easily than in Poland, directors of companies tend to quote insufficient working capital and insufficient capital overall as two of the major reasons for business failure (Storey 1994). Moreover, the reliance on retained profits of Polish firms means that the investment must be funded from the current income, hence is limited by the profitability of the firms. Even though the vast majority (80 per cent) of surveyed firms (225 firms) reported a profit after tax in the year ending December 1994, with half of the firms even reporting a profit of more than five per cent of sales turnover in that year, it is not likely that these profits were sufficient to meet the financial needs of the firms, especially as the vast majority of surveyed firms (88 per cent) has been growth orientated in 1993-94; in fact, nearly two third of the firms (62 per cent) considering growth as an important objective. The extent to which personal savings are available depends on the accumulated resources of the owner. However, the level of per capita gross saving is relatively low in Poland, accounting

[5] Figures relate to 264 of the surveyed firms that did invest in the 1993-94 period.
[6] See Keasey & Watson 1995.

for USD 1,162 which is three times lower than in the UK and over four times lower than in Germany (Piasecki et al. 1998). This is not surprising, bearing in mind the abolition of private ownership during the communist period and the fact that money was only used to a limited extent as a store of value, combined with high inflation rates in the 1980s and early 1990s (Buch 1996, Wyczanski 1993, G2 Economics of Transition 1995). It is therefore also not surprising that Polish small start-ups are less capitalised than those in more mature market economies. A survey of 48 small Polish firms undertaken by Erutku & Vallee (1997) notes that 63 per cent of firms started trading with less than $5,000, compared to only 18 per cent of American firms.

Consequently, the progress of Polish firms is constrained by the lack of finance: 262 of the 300 firms surveyed in 1995 identified finance as a barrier in their development and 80 per cent of the surveyed firms showed an interest in raising additional finance with 40 per cent even showing a strong interest. The RWI confirms this by noting that 51 per cent of surveyed firms had financial problems during start up and about 60 per cent did not have sufficient internal capital to finance the running of the business or investments (RWI 1994).

3.4.2 External sources

The efficient and effective provision of external finance to small firms has long been recognised in the UK and elsewhere as a key factor in ensuring that those firms can grow and compete (Binks et al. 1992). In some cases the availability of external funds might even be vital for the survival of the firms, for example in cases where internal sources are insufficient to provide the working capital needed to keep the firm running. External finance is available in the form of debt finance or external equity.

3.4.2.1 Debt finance

In the UK, the vast majority of small businesses use debt provided by the banking sector and trade credit as main source of external finance. An analysis of the published accounts of 110 UK small firms in the UK over the period 1986 to 1990 notes that bank finance provided about 31 per cent of the overall funding of small firms in 1990, consisting of 17 per cent short-term (overdrafts) and 14 per cent longer-term loans. Trade credit ranked second in proving 17 per cent of the overall funding (Keasey & Watson 1995). A survey of 5589 members of the Forum of Private Business (FPB) in 1994 showed that 72 per cent of firms had a overdraft facility with 47 per cent being used and that 40 per cent of firms had a bank loan. However these particular high figures are not wholly representative for small businesses in general as the sample had a bias towards larger businesses and those making more active use of their banks (Binks & Ennew 1996). The high reliance on short term finance provided by banks (short term loans and overdrafts) and relative importance of trade credit (in comparison to larger firms) are two of the persisting characteristics of the financing structure of small firms (Hughes 1992). Hughes (1992) also identified a lower ratio of fixed to total assets in smaller companies than in larger companies, which, may reflect the smaller firms desire

towards flexible production or service methods. However, this could also be the result of difficulties experienced by small firms in accessing long termed debt finance or equity.

In Poland, bank loans have been available since the reform of the banking sector in 1989, however SMEs are still reported to have only limited access to them (Welter 1994). In the 1995 survey only 37 per cent of the 300 surveyed firms had actually obtained bank finance since start up and according to the RWI survey only about 13 per cent of start ups use bank loans as part of their initial capital (RWI 1994a). Domestic banks are hesitant about lending to SMEs and foreign banks tend not to be interested in lending to SMEs (Suzuki 1996). In other words, credit terms are much less common in Poland than in more mature market economies. Although trade credit is not mentioned in the literature as a source of finance for SMEs in Poland, it does exists. In one of the case studies (Case 2) the owner had an opportunity to buy two machines by paying 50 per cent of the price in cash and receiving a credit from the supplier for the remaining half of the costs. In another company (Case 7) trade credit played a significant role. The credit is mainly offered by large foreign companies who allow about 30 days for the payment.

An alternative to banks are public support programs offering loan finance or even grants, which are funded by the Polish government as well as foreign national and international organisations (Appendix I). However, many of the schemes proved to be unsuitable for SMEs, as they are either overly bureaucratic or are more interested in larger projects. For example, the long-term *World Bank loan for the development of the private sector*, which is administered by the Polish Development Bank, is only given following agreement with the World Bank, which means it is overly bureaucratic. The *PHARE Loan programme*, despite a guarantee option, has been of limited efficiency because of problems with the managing bank and regional restrictions and the European Investment Fund Loan is irrelevant for SMEs as it is considered mainly for large investment projects (RWI 1994b).

Nevertheless, there are programmes which are more suitable for SMEs, such as the *BGK loan guarantee programme* and the *Programme for Structural Development in Selected Regions in Poland (STRUDER)*. The *BGK loan guarantee programme*, which has been designed for SMEs, is administered by Bank Gospodarstwa Krajowego (BGK) in co-operation with 12 large commercial banks. The program had been funded by the Polish Ministry of Finance and aims to support SMEs to increase export sales, to introduce new technology and for certain other purposes (see chapter 6.4 for more details). The *STRUDER* programme was implemented by the Polish Agency for Regional Development (PARD) in April 1994 and provides support for regional institutions, training and advisory services, regional financial support for SMEs and undertakes small infrastructure projects. The financial support for SME is given in the form of a grant scheme as well as a loan guarantee scheme in six selected provinces of Poland. The voivodships selected were: Walbrzych, Lodz, Rzeszow, Olsztyn, Suwalki and Katowice. The main source of funding is the PHARE programme of the European Union. SMEs can apply for the grant in Regional Development Agencies (RDAs) in each of the six regions. The grant is a non-repayable grant of up to 25 per cent of the cost of investment in mainly fixed assets. A minimum of 20 per cent has to be contributed from the

entrepreneur's own resources (a minimum of 15 per cent for projects over 200 000 ECU) with the balance coming either from more of the entrepreneur's own resources or from bank credit. The maximum level of grant for any one project is 100,000 ECU.

To be eligible for the STRUDER grant, firms have to:

- be privately owned
- employee not more than one hundred employees.
- be active in the manufacturing or service sector, including transportation, tourism and agribusiness.
- locate the investment (fixed assets only) in the region only
- demonstrate sound management and evidence of project viability
- have no tax or social security indebtedness.

(Kozak 1996, EURO INFO Correspondence Centre 1995)

The guarantee fund within STRUDER was designed to partially compensate banks for the risk involved in lending to SMEs which are participating in the grant scheme (EURO INFO Correspondence Centre 1995).

At the end of April 1995 grants for over 200 projects had been approved, totalling nearly 7 million ECU. The total investment by the SMEs involved (all of which employ less than 100 people) amounted to almost 30 million ECU in some of the most disadvantaged regions in Poland (Kozak 1996). In fact, two of the case study firms applied for a STRUDER loan, Firms 7 and 4, which gives some insight into the working of the scheme. Firm 7 received the loan in 1994, Firm 4 could have received the loan had they internally agreed on how much and in what to invest. However one of the criticisms of the programme (mentioned by Marek Kozak, the Director of the Polish Agency for Regional Development) is that the scheme appears to be overly bureaucratic for the smaller investment projects. He also suggests that it might be preferable if the upper limit for employees was higher than the 100 persons which it is at present. In general he points out quite rightly that any regulatory system should be kept as flexible as possible so that the scheme can be adapted to meet the actual needs of SMEs, rather than rigidly trying to meet the needs anticipated at the outset (Kozak 1996).

However, the awareness among small firms about the availability of public support programmes appears to be rather low. This problem is also known in more mature market economies as pointed out by Keasey & Watson (1993): "The typical small firm operates in a low information and highly uncertain environment. It is clear that the problems faced by small firms in obtaining external finance is in part a reflection of low information availability and the high fixed cost of obtaining information" (Keasey & Watson 1993). This is supported by two of the case study firms (Case 3 and 7) who received loans from western credit lines which were made available via the Powszwchny Bank Gospodarczy (PBG - one of the nine regional state owned banks) in 1991. Both had heard about that option through informal connection, e.g. friends. Another case study firm (Case 6) mentioned that 'soft' loans, e.g. with lower then normal interest rates, exist but that there is not enough information about these credits available. For example, one month before the interview the entrepreneur read in the newspaper that it would be possible to receive a loan from the city council and

that information about this would be available at the city council. According to the newspaper it was an attractive loan with lower than normal interest rates. It included the possibility to repay part of the loan after a few months, which then would be free of charge. However when he sent someone to the city council, nobody could tell him anything about this loan.

3.4.2.2 External equity

External equity, or venture capital, means that an outside investor becomes a partner of the business, therefore owning part of the business by investing in the equity of the firms. Venture capital provision exists in two forms, as formal and as informal venture capital. Formal venture capital is provided by institutions such as equity funds, banks, insurance companies etc. Informal venture capital on the other hand is defined by Gaston (1989) as equity and near-equity risk finance invested by private individuals directly in unquoted businesses without the use of formal intermediaries (Harrison & Mason 1995). These informal investors, often termed as 'business angels', are specific individuals who wish to become involved in the financing of higher-risk projects in smaller, often entrepreneurial firms (Binks & Ennew 1996). In the following section the development, characteristics and investment criteria of both formal and informal venture capital will be explained.

Formal venture capital

The American Research and Development (ARD), introduced by General Georges Doriot, a professor at Harvard Business School in 1945, is commonly accepted as the first modern venture capital fund. By 1987 about 600 independent private venture capital funds existed in the USA, providing US$4.2 billion of equity finance (NVCA 1992 in Murray 1995). In the UK, the formal venture capital market began to develop rapidly during the early 1980s. The British Venture Capital Association (BVCA), founded in 1983 by 36 founder members, had 124 member in 1989 and invested a record £1.42 billion in 1,302 UK companies (BVCA 1992 in Murray 1995). In Poland the venture capital market has just begun to develop, hence the availability of formal external equity finance is still very limited. By 1997, 25 venture capital funds existed, nearly 99 per cent funded by foreign governments, institutions and companies. Moreover, the majority of investments (64 per cent) were made in larger firms with more than 250 employees (Piasecki et al. 1998).

SMEs experience difficulties in accessing external equity, even in countries with a developed venture capital sector . This is because since the late 1980s, the venture capital industry shifted away from its traditional concern with financing early stage investments and concentrated more on larger investments in mature firms, particularly management buy-outs (MBOs) and management buy-ins (MBIs - Mason & Harrison 1994, Freear et al. 1995, Mason & Harrison 1993). Hughes (1992) estimates that less then 17 per cent of venture capital funds are used for projects with a value up to £ 250,000. According to the Bank of England report (1998) only 5 per cent of the value of venture capital managed by the BVCA has been invested in early stage investments. The trend is also evidenced in statistics for continental European venture-capital industries. France, which has the biggest venture-capital industry in Europe after the UK, invested only 3.1

per cent of their total funds worth 6.9 billion FFR in seed and start-up funds in 1991, a decline of a quarter form the previous year (EVCA 1992 in Murray 1995).

However this tendency is understandable as equity investment in SMEs is unattractive for many institutional investors for several reasons:

- SMEs and especially new SMEs are more risky to invest in because of their high failure rate (Storey 1994).
- Due to the characteristics of new business start-ups, their growth potential is highly uncertain or at least extremely difficult for outsiders to judge.
- The evaluation and monitoring costs involved in equity financing are more or less fixed which makes larger investments more profitable. Monitoring costs of investment in small and young firms are likely to be even greater than in larger firms due to the inherent personal way of managing the firm, as well as difficulties with clearly differentiating between the owner's personal finances and those of the business (Harrison & Mason 1995, Binks & Ennew 1996).
- Exit routes for investments in smaller firms are more difficult to find as their shares are not traded. Therefore the investment is highly illiquid for the venture capitalist which makes it more problematic to realise any capital gain. It also further increases the risk as it might not be possible to exit quickly and costlessly from the investee firm in the event of its poor performance or failure (Murray 1995).

In this context, it is not surprising that venture capitalist funds apply very strict criteria when judging investment proposals. Businesses that are likely to be funded have to be fast-growing and capable of providing an annual return of 30 to 60 per cent (Mason & Harrison 1994). As mentioned above, the evaluation and monitoring costs are quite high. For example, initial accountancy and legal fees range between £50,000 and £70,000, which makes investments under about £250,000 (US$ 400,000) uneconomic for the venture capitalist. In fact the average size of venture-capital investments amounted to £910,000 in 1990, preferably in from of MBOs and MBIs (Mason et al 1994, Murray 1995, Harrison & Mason 1995).

Realising the market imperfection in providing smaller amounts of equity finance to SMEs, public bodies in the UK decided to support the creation of venture capital funds directed towards small and medium sized businesses. The rationale for this intervention was based on the positive contribution of SMEs to the economy, in particular regarding job-creation and income generating effects. Between 1992 and 1993 a network of 11 regional enterprise funds were set up funded by Midland Bank, Lincolnshire TEC and a number of individuals. The funds aimed to invest smaller amounts of less then £125,000 in SMEs but still to produce level of returns high enough to attract institutional investors (Boocock et al. 1995). Another example is the Merseyside Special Investment Fund (MSIF) which is funded jointly by the European Regional Development Fund, the UK Government, the Merseyside local authorities' pension fund and the Pilingston's pension fund, with further support from the European Investment Banks in form of guarantees. The fund provides equity finance, unsecured mezzanine loans and loans to small businesses. Since August

1996 MSIF has made 130 investments, a total of £5mn, which have attracted a further £19mn from private equity providers and banks (Bank of England 1998). Venture Capital Trusts (VCTs) were created by the 1995 Finance Act with the aim to invest in new shares and securities of unquoted companies. Between August 1995 and September 1997 eighteen VCTs invested £90.6 million, sixteen per cent of which (£14.6 mn) in early stage businesses (Bank of England 1998).

In Poland, support programs offering equity finance have been established, which are supported by the Polish government as well as foreign national and international organisations. However, similar to the schemes for debt finance, the programmes are mainly designed for larger projects. For example, the *PHARE Equity programme* is only available to those firms that have received European Investment Bank loans, which are irrelevant for SMEs, as they are mainly considered for large investment projects. Moreover, the Export-Development Bank which is involved in the administration is mainly orientated to state companies (RWI 1994b). The *Pioneer Investment Poland Equity Fund* and the *Polish Private Equity Fund* both start investments from US$ 500,000 and are therefore only suitable for medium sized and large companies. The *East European Food Equity Fund* starts investments from 2 million US$ and the *DBG Osteuropa Holding GmbH Equity Fund* even starts investments from 5 million US$.

Nevertheless, the *Renaissance Equity Fund* might consider investing in emerging private enterprises, including start-up and young growth companies, management buy-outs and spin-offs of small state-owned businesses. It makes initial investments in the range US$ 100,000 to US$ 500,000, and follow-on investments will be made as appropriate, with ultimate portions being in the range of US$ 1.5 million to US$ 2.5 million (EBRD 1998). This might therefore be suitable for SMEs, however more for medium sized businesses, as small firms typically are in the need of about US$ 40,000 (see section 4.3).

However, as in the case of the other public support programmes, it appears that the firms are uninformed of existing venture capital funds, like for example the *Renaissance Equity Fund* which could be used by medium-sized firms. This is supported by one of the key informant, a business adviser at the Chamber of Commerce in Nowy Sacz (South Poland), who mentioned that SMEs in his region are poorly informed about the existence of venture capital funds in Poland (mainly in Warsaw). Worse, even some support organisations seem to be unaware of available equity programs. For example, a key informant of the Lodz Region Economic Redevelopment Foundation mentioned that venture capital funds for SMEs do not exist and that firms would have no possibility of getting external equity finance. It is therefore not surprising that one of the case study owner-managers (Case 1), who showed an interest in external equity cited that he would not know how to obtain external equity.

In contrast, the situation for SMEs in the UK has further improved, as recently banks have begun to show more interest in offering equity finance to small firms. All major banks in the UK have venture capital subsidiaries, for example Barclays Development Capital Limited and Basonsmead Fund . Midland provides equity through the above mentioned Regional Enterprise Funds and through its SME venture capital

subsidiary, Midland Growth Capital. Some of the banks have even launched equity option loans, as for example Lloyds in 1997 (Bank of England 1998). The underlying motivation in providing equity to small firms is, as argued by the Bank of England (1996), the provision of it as part of a financial package, rather then any profits that may result from the equity deal itself. The market for money transitions and other financial products has become increasingly competitive with building societies and other organisations such as supermarkets entering the market (Bank of England 1998). Therefore the bank might offer equity finance to small firms not in order to make a profit out of the equity deal but to gain the firms as a customer for other financial products.

Moreover in recognising the importance of a suitable exit route for venture capitalists investing in smaller firms as well as the lack of a market for shares of smaller firms in general, the Alternative Investment Market (AIM) was established by the London Stock Exchange (LSE) in 1995. Listing on the AIM is cheaper and easier then at the LSE. By the end of September 1997 294 companies were listed, including 20 from overseas, with a total market capitalisation of £5.5bn (Bank of England 1998). Another market, OFEX, which is independent of the LSE, was established in 1995 as an unregulated market. The costs involved in listing at OFEX are comparable with those of AIM, however the listings conditions are more relaxed. At the end of November 1997, 117 companies were trading on OFEX with a total market capitalisation of £ 2.1bn (Bank of England 1998). In 1996 a European market had been launched, the European Association of Securities Dealers Automated Quotation System (EASDAQ), aiming at small, fast-growing companies. However as small companies preferred listing on domestic markets, EASDAQ now targets medium sized enterprises (Bank of England 1998). In Poland, a capital market has existed since the opening of the Warsaw Stock Exchange (WSE) in 1991, which is divided into three markets: the Main market, the Parallel market and the Free market. Whereas the first two markets are unsuitable for SMEs, the Free market could become an important source of financing for SMEs. Yet until the end of October 1995 not one company was listed on the Free market. It has not been attractive for issuers as listing on this market carried with it the stigma of being viewed as a high-risk company (Suzuki 1996).

Informal venture capital

As the provision of small amounts of equity from venture capital funds virtually disappeared during the late 1980s and early 1990s, business angels become more significant as equity source for small businesses in the USA as well as in the UK (Freear et al. 1995, Binks & Ennew 1996). The MAS 'Business Line' survey for Barclays Bank in 1988, which consisted of 2,000 interviews of businesses with less then 50 full-time employee, notes that 2 per cent of firms raised equity from private investors; only family and friends (4 per cent) and banks, including their venture-capital subsidiaries (9 per cent) were more significant as a source of equity finance (Harrison & Mason 1995). Only three years later a survey undertaken by the Small Business Research Trust in the UK showed that 3 per cent of respondent used 'other private individuals' as a source of equity finance compared to only 0.8 per cent that cited 'venture capital' (Harrison & Mason 1995). According to the Bank of England (1998) business angels make approximately 10 times as many

investments as formal venture capital funds in early stage businesses and invest nearly four times as much in total.

A study by Freear et al. (1995) of 284 new, technology-based firms founded in New England between 1975 and 1986 notes that of the 177 (62 per cent) firms which raised outside equity 70 per cent received funds form private individuals and 51 per cent from venture capital funds. These high figures may be explained by the fact that these firms were founded in a time of rapid growth of venture capital and that most of these funds were invested in new, technology based firms. Nevertheless the study made the distinctive role of angels in smaller deals evident by showing that out of the 110 investments below US$ 250,000 93 per cent were provided by informal venture capitalists (Freear et al. 1995). Gaston (1989) identified the average investment size by a US angel at just under US$ 60,000 (Mason & Harrison 1994). Surveys in the UK have suggested that UK angels invest even smaller amounts. A study of 86 actual and potential informal investors in the UK by Mason and Harrison in 1994 concluded that just over half of all investments involved amounts of under £10,000 (US$ 16,000) where as only 12 per cent of investments involved amounts larger then £50,000 (US$ 80,000 - Mason & Harrison 1994).

The fact that informal investors generally operate at the lower end of the investment size range is certainly one of the reasons why they proved to be a suitable source of equity finance for SMEs. Other reasons are explained by the characteristics of business angels, which are fairly well analysed although it is difficult to gather information about them as they have a preference for anonymity, hence operate in an invisible market (Mason & Harrison 1994). Business angels typically are high net worth individuals who have personal entrepreneurship experience, normally with backgrounds in industry and commerce. Generally, they learn of funding opportunities through their business associates and friends and keep a close working relationship with the firm they invest in (Harrison & Mason 1995, Freear et al. 1995, Mason & Harrison 1993). These characteristics in combination with the fact that most angels already have or develop prior knowledge of the sector and the business they are investing in reduce the evaluation and monitoring costs significantly. The lower evaluation cost, in comparison to formal venture capital, stem from the more personal approach which makes the preparation of detailed market analysis unnecessary and reduces the accountancy and legal fees (Harrison et al 1995). Moreover the majority of informal venture capitalists do play an active role in the firm they invest in, either by joining the board of directors, providing informal consulting help or working full or part-time in the business (Freear et al. 1995). In other words, the informal investor becomes more of an insider to the firm, thus reducing the information asymmetric problem which leads to lower costs in monitoring.

In addition the investment criteria applied by business angels are less strict than those applied by venture capital funds. Expected annual rates of return on investment are normally within the 15 per cent and 30 per cent range (Harrison et al 1995). Bearing in mind that business angels are reported to be more active in new firms or firms in the early stage of their development than venture capital funds, thus investing in high risk deals, the lower expectations regarding returns on investment seem even more counterintuitive. One

explanation might be that many individual venture capitalists are also motivated by non-financial attributes of the investment. Research undertaken by Wetzel (1983) noted that half of the angels accept lower returns or higher risks when they expect the firm they investing in to create jobs in their communities, commercialise socially useful technology, assist women entrepreneurs or entrepreneurs from ethnic minority groups. Thereby the most important non-financial factor for angels is to play an active role in the firms thus assisting the entrepreneur to build a successful business, an observation which has been confirmed by other surveys (Freear et al. 1995, Mason & Harrison 1994, Harrison & Mason 1995).

As one of the most often mentioned reasons for not willing to consider external equity stated by SME owner-managers is the fear of losing their independence and the control over the business activities, it is interesting that research in the USA and the UK has shown that in the majority of cases the business angel only held a minority stake of the business, thus only minority voting power in the firm (Harrison & Mason 1995, Mason & Harrison 1994). However, the informal investor may of course still expect a significant say in the strategy of the business which can be positive as well as negative. According to Freear et al. (1995) about 75 per cent of SMEs owner-manager who had a working relationship with their angel thought it to be productive, where as Mason & Harrison (1994) argues that '... the clash of two strong egos may create conflict between entrepreneur and angel.' However even if the business angel does not interfere significantly in the business activities, there is still the question of what will happen once he decides to exit from the investment. Interestingly a study in the USA by Gaston (1989) noted that most business angels expect to exit by selling their shares to company insiders (ref. to Mason & Harrison 1994). In the UK however, surveys concluded that investors tended more to sell to outsiders, namely other companies or by flotation on the stock market (Mason & Harrison 1994).

Another problem linked with finance from business angels is the highly invisible market, hence the difficulties in finding a potential business angel in the first place. To overcome these problems 43 business angel networks (BANs) have been established in the UK, aiming to bring potential investors and firms seeking equity finance together. Some of them are supported by banks and Nat West even runs its own matching service, the Nat West Angels Service. Indeed, according to the British Venture Capital Association (BVCA) which provides lists of national and regional business angel networks, in 1996/97 over £19mn was invested by 373 business angels in 192 UK companies of which 44 per cent were part of a larger financial package provided by banks (Bank of England 1996 and 1998). This is an interesting model, as a business angel who might not have the knowledge necessary to distinguish between a prospective and non-prospective investment opportunity, can draw on the experience of other investors such as banks or venture capital funds. However, it is questionable whether this might be a successful solution for Poland, as data about business angels are not available and banks are not interested in providing equity to small firms. Nevertheless, the model might have some potential in a modified version. Small business support agencies in Poland, which are familiar with the SMEs in their local area, could operate business angel networks, aiming at finding Polish (for example Polish emigrants who have been in the USA during Communism and who are now coming back to Poland, as mentioned by one of the key informant from the Chamber of

Commerce in Nowy Sacz) as well as foreign investors via modern communication systems such as the Internet. It might even be possible to include business angels in public and foreign support programmes, instead of relying on financial packages provided by banks. Considering the tendency of business angels to keep a close working relationship with the firm, potential German business might be especially interested in investing in Polish firms because of their relatively short travel distance to Poland.

3.4.2.3 Other sources of external finance

Financial instruments like hire purchase and leasing are also available in Poland, however they are hardly used as a source of finance by small firms. Two of the banks interviewed (Bank 1 and Bank 3) are offering leasing service for SMEs, but according to the 1995 survey only about six per cent of firms that did invest in 1993-94 mentioned hire purchase or leasing as a source of finance for investments, typically accounting for 2.7 per cent (mean) of the amount invested. Two of the case studies also referred to leasing as part of their current financial structure. In one company (Case 5) the leasing of one car and few machines accounted for about 10 per cent of the current resources and another business (Case 6) used leasing even to a lower degree for few machines.

3.5 Key points in chapter 3

- Under communism, hardly any sources of external finance for SMEs existed in Poland.
- Dept finance provided by banks is available in Poland since 1989, however SMEs have only limited access to it.
- Up to now, SMEs in Poland, both for start up and investment, have to rely to a greater extend on internal funds that their counterparts in more mature market economies.
- Banks are the main provider of debt finance, in the UK as well as in Poland.
- Public support programmes offering debt finance or/and external equity are often unsuitable for SMEs.
- Polish SMEs are uninformed about existing public support programmes.
- Polish banks do not offer equity finance for SMEs, whereas all major banks in the UK have venture capital subsidiaries.
- In Poland, a stock market for SMEs does not exist, whereas two markets aiming at small firms are operating in the UK since 1995.
- In the UK and the USA, informal venture capital (Business Angels) became more important as a source of external equity for SMEs than formal venture capitalists.
- In the UK, 43 business angel networks are operating, aiming to bring potential investors and firms seeking equity finance together.
- Information about Polish business angels are not available.
- In Poland, small business support agencies could operate business angel networks, aiming at finding Polish as well as foreign investors via modern communication systems such as the Internet.

4. FINANCE AND SMEs: PREFERENCES, NEEDS AND PROBLEMS

4.1 Introduction

Chapter four deals with the demand side of finance, the preferences of SMEs for certain types and amounts of finance and strategies of firms in accessing finance or dealing with a shortage of finance.

4.2 Preferences of SMEs with regard to their source of finance

4.2.1 Reasons why SMEs prefer certain sources of finance

When discussing the factors which influence decisions made by SMEs with regard to their sources of finance, it is important to understand the characteristics of SMEs. In the majority of cases SMEs usually are managed and owned by the same person(s), which means that owner-managers of SMEs are not accountable for their actions towards any third parties. Therefore in SMEs, the owner-manager's personal approach towards issues such as debt financing directly influences the company's behaviour. Bearing in mind the relatively undiversified assets portfolio of the owner-manager, as the investment in the business often constitutes a major portion of the owner's personal assets, this means that any business risks are in fact personal risks for the owner (Keasey & Watson1993, Ang 1991). This is certainly also valid for SMEs in Poland. The vast majority (80 per cent) of surveyed firms in 1995 were owned by one or two persons and the financial structure of SMEs in Poland as outlined in section 3.4.1. confirms that the assets of the business consists mainly of personal assets of the owner(s). Therefore it is fair to argue that the personal characteristics and circumstances of the business owner play an important role in the financial decision of the firm. For example, the reason why the owner-manager initially started the business, e.g. to seek independence or to increase the personal income, is likely to influence the business aim, e.g. whether or not growth is an objective for the firm, as too much business growth might mean that the owner-manager can not stay in total control of the company which might jeopardise the initial reason for starting the firm. Once again the business objective will influence the financial choice of the firm as internal funds might not be sufficient to fund the investment needed by those firms that are interested in growth. However, owner-mangers of small firms are unlikely to have a single overriding aim in establishing and running their business. Their aims are inclined to be numerous and complex (McMahon & Stanger 1995).

Polish SMEs are not an exception to this. The main reasons why Polish SME owners started the business are to seek independence (70 per cent), to increase income (60 per cent) and to gain self-fulfilment (over 50 per cent) (Smallbone et al 1996). However 41 per cent of firms that mentioned 'to seek independence/autonomy' as their main reason for starting the business mentioned 'to improve living standards/increase income' as second main reason and 44 per cent of firms that mentioned 'to improve living standards/increase income' as their main reason for starting the business mentioned 'to seek independence/autonomy' as second main reason. In comparison, research in the UK has revealed that between 30 and 50 per cent of business owners started their firms mainly to seek independence, where as

only about 20 per cent of firms reported income related motives to be most important (Gray 1992). This suggests that starting up a business in Poland is done not only to be independent and in control of the firm but as a possibility of increasing the standard of living especially against the background of declining large state companies. It could also mean that the managers do not trust the large companies to provide employment with prosperous futures as they failed to do so in the past.

On the basis of the Polish owner-managers being keen to increase their income, one would expect them to be quite growth orientated, especially considering the fact that this form of income generation was not available for the Polish people for about 40 years. It is therefore not surprising that in the 1995 study 88% of surveyed businesses (261 firms) had been seeking growth in 1993/94: moreover, for the majority of firms (62 per cent) growth had been an important objective. These figures are, as expected, higher than those in the UK. For example a survey of 139 manufacturing firms in South London notes that 55 per cent of surveyed firms had been aiming to grow during the 1991-94 period whereby only 37% reported a strong growth objective (CEEDR 1994).

At the same time seeking independence is even more frequently mentioned by Polish owner-managers as a reason for starting up a business. That could influence the growth aim of the owner-manager as soon as the business growth has to be financed with external funds. In other words as soon as internal funds are insufficient to finance the growth of the firm the owner-manager has to decide whether he/she wants to slow down growth in order to stay independent or whether to seek external finance, hence gives away part of the independence, in order to grow and to increase income. This conflict is well documented in the literature. Rader (1987) for example mentions that " increasing value while maintaining control of the firm is the main task facing business owners" and Brigham (1992) points out that ".. there is value to being in control, and that value is not easily measured. As a result, we often observe small businesses taking actions, such as refusing to bring in new stockholders even when they badly need new capital, that do not make sense when judged on the basis of value maximisation but that do make sense when seen in the light of the personal objectives of the owner. " (McMahon et al 1995). In this context, Scase (1997) suggests that, as a result of the experiences under communism, small firms in Poland were mainly set up to conduct "spheres of personal autonomy". He argues that Polish owner-manager were more proprietors, aiming to trade in order to generate surplus to increase living conditions (hence to consume) than entrepreneurs, committed to capital accumulation and business growth (hence to investment). Following this argument, one would expect the growth orientation of Polish SMEs to decrease as soon as firms of proprietors reached a size sufficient to generate enough income to realise the standard of living desired by the owner-manager.

Because of this fear of losing independence, control and freedom of managerial actions, SMEs are often reported to be rather reluctant to use external equity. However, the agency cost involved, such as initial accountancy and legal fees as well as cost resulting from the need of outside investors to monitor the movements of the firm to ensure proper use of their assets, may be also of importance (Mason & Harrison 1994, Harrison & Mason 1995). Although agency costs exist in every form of external finance due to the

problem of asymmetric information, the cost of external equity is likely to be greater than for debt finance. First, for the investor the profit potential of the firms is harder to monitor than its debt-paying potential. Providers of equity finance need to observe all aspects of a business operation on a continuous basis whereas debt providers just need to monitor the ability of firms to service their loans. Banks are probably in the best position to do so cheaply through the bank account which the firm is likely to hold with the bank. Second, equity investment necessitates long-term commitment of funds with little scope for renegotiating where as debt finance is more likely to be agreed on a more short-term and frequently reviewed basis, secured on business and/or personal assets which enables the debt finance provider to prevent the firm from undertaking excessively risky projects (Keasey & Watson 1993, Harrison et al 1995).

However venture capital still has certain advantages compared to debt finance. Because of the long-term nature of equity finance it is ideal for the funding of long-term investments, especially as the primary reward for the providers of venture capital is based on eventual capital gain rather then on interest rates, which makes the cost calculation for the firm much simpler. Even though the initial fees when accessing venture capital might be higher than those involved in debt finance, no running costs arise apart from those created by the monitoring process. This makes the firm less vulnerable especially in times when bank-rates are increasing and economic activity starts to slow down as experienced in the UK after 1989 (Murray 1995). Scope for venture capital also arises in firms that are credit-worthy but can't attract debt finance for other reason, e.g. the lack of a track record or insufficient collateral to secure the loan. In times of economic recession it might also be that the main provider of debt finance, the banks, apply more conservative lending practices to improve their capital/asset ratios which happened in the USA as well in the UK in response to significant loan losses during the 1980s (Mason & Harrison 1993).

The Wilson Committee in 1979 suggested that as many as 75 per cent of small businesses in the UK would resist any external participation in the equity of the company. More recently Binks et al. (1990a) suggested that as many as 85 per cent of small business owners may resist external equity participation because of concern about a loss of control, while Cowling et al. (1991) quote a figure of 61 per cent (Binks & Ennew 1996). Nevertheless, as emphasised by reports of the Bank of England, equity finance could be a potential source of finance for growth orientated firms, especially when they are facing problems with bank finance for reasons which are not connected with the viability of the firm or the project for which finance is thought. It is therefore quite promising that Polish firms seem to be less reluctant towards external equity. In the 1995 survey 53 per cent of surveyed firms stated that they would be willing to consider external equity with 16 per cent showing a definitive interest. The figure become even more significant when looking at firms that were interested in raising additional finance as two thirds of these firms (66%) showed an interest in external equity. Because of the potential high expectancy of external equity by Polish small business owners, which might be a result of their difficulties in accessing debt finance from banks, venture capital could become quite an important source in the financing of Polish SMEs. However not all firms interested in external equity are necessarily potential receiver of external equity as they might not meet the investment criteria set by venture capitalists.

4.2.2 Analysis of firms that tried to obtain debt finance

The importance of the personal characteristics of the business owner in the financial decision of the firms in combination with the fact that that independence is one of the main objectives of most entrepreneurs might explain why SME owner-managers, if they need external finance, mainly try to get it from of debt finance. Debt finance leaves the owner-manager in control of the business, is potentially available from banks in the region and even more important, it is generally known that banks provide debt finance. The downside are the costs involved in form of interest rates and the collateral demanded by banks (see chapter 5.5). In the 1995 survey in Poland 177 firms indicated that they had at least once tried to get access debt finance since start-up, which represented 59 percent of the 300 firms surveyed. 168 firms applied for a loan to a domestic bank, 11 firms applied for a loan to a foreign bank (of which 4 had also applied for a loan at a domestic bank) and four firms contacted other sources of debt finance.

As the wish of the owner-manager to expand or not to expand the business influences the financial decision of the firm, the growth orientation of the 300 firms surveyed in 1995 will be examined regarding their attempts to access debt finance.

Apart from personal preferences, other factors might force the firm towards or away from debt finance, which might not be under the control of the owner-manager. For example firms that experience cash-flow problems might have no other choice but to seek external finance in order to avoid insolvency. This is even more relevant as cash flow shortages are one of the major constraints on SME development in Poland (Smallbone et al. 1996) and the above noted percentage of firms seeking bank loans includes requests for overdraft facilities. Furthermore, firms might also have to invest funds that are beyond available internal financial means in order to survive in the new market environment with increasing competition form within Poland as well as abroad. Even though questions about the situation of firms at the time when they applied for debt finance were not covered in the 1995 survey, evidence from the case studies suggests that these push factors indeed exist. Three of the firms (Case 1, 3 and 7) mentioned increasing competition as one of the main factors for the firm's need to invest. On the other hand, even though interested in debt finance provided by banks, not all small businesses have access to the collateral demanded. Therefore, some firms are excluded from this source of external finance. As smaller firms typically have a lower ratio of fixed asses to total assets when compared to larger firms (Hughes 1992), smaller firms might have more difficulties in providing sufficient collateral than larger firms. Therefore, it seems fair to argue that smaller firms are less likely to apply for bank loans than larger firms.

Moreover, it appears that bank loans as wells as foreign credit lines were more available in the beginning of the reform, especially in the years 1990 and 1991, than in the following years (see chapter five for more details). Therefore it could be argued, that whether or not a small firm tries to apply for debt finance might be influenced by the expectations of the owner manager to be successful. In other words, even though the firm is in need of external finance, the owner might not even try to apply for a loan in times when debt

finance is not or only to a limited extent available. Unfortunately, the question in which year the firms applied for the loan has not been asked in the 1995 survey, which is why this factor could only be discusses with data provided by the case study interviews .

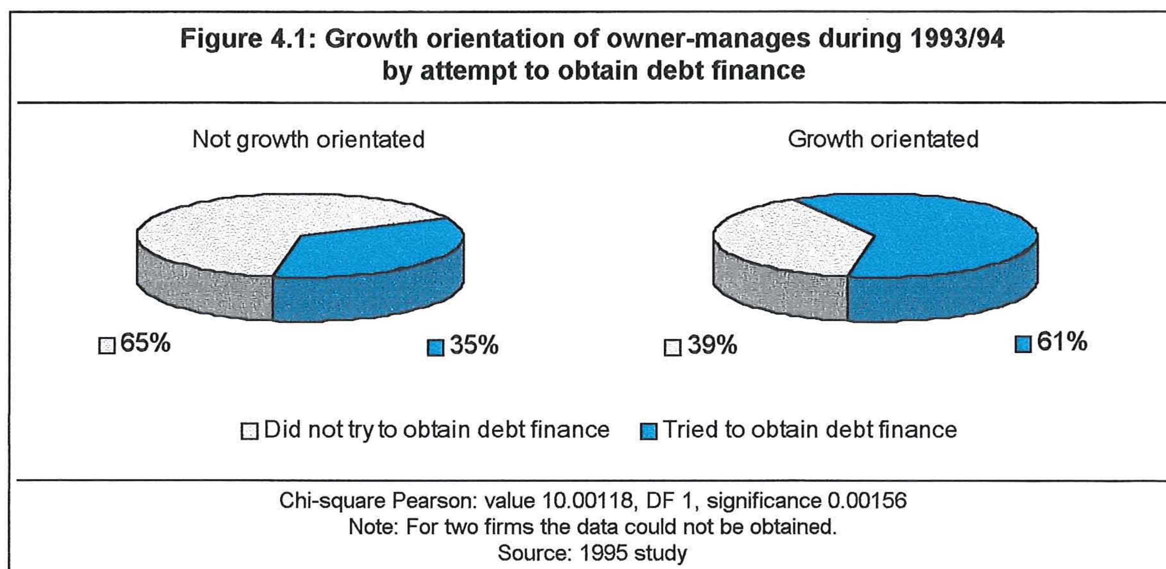
Following the above, the analysis will examine the following factors with regard to the attempts of the owner-managers to access debt finance:

1. The growth orientation of the owner-manager(s).
2. The size of the firm.
3. The year in which the loan application took place.

4.2.2.1 Growth orientation of owner-managers

Analysis of the 1995 survey reveals a significant (chi-square sign. = 0.00156) relation between the growth aim of firms and their wish to raise debt finance. Nearly 63 per cent of firms that aimed for growth in 1993/94 had tried to get a loan since start up compared to only 35 per cent of firms without growth (Figure 4.1). The case study firms confirm these findings, as five of the seven owner-manager interviewed had plans to develop their business. This emphases the potential role banks could play in small business finance in Poland.

Figure 4.1: Growth orientation of owner-manages during 1993/94 by attempt to obtain debt finance

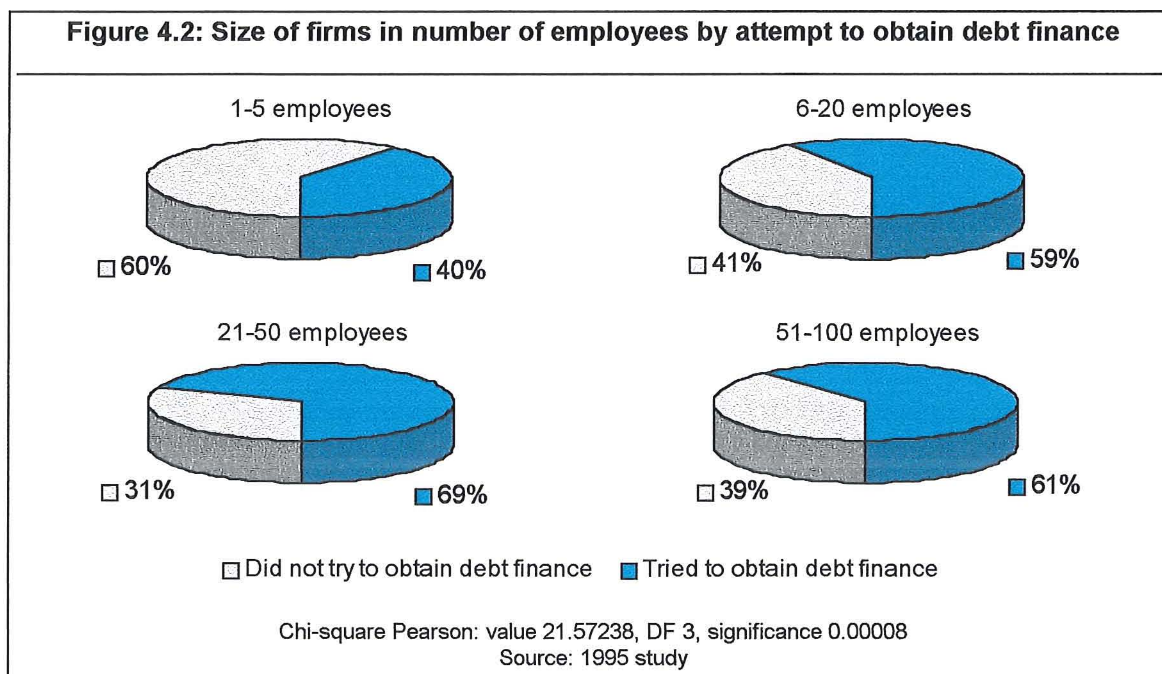


Chi-square Pearson: value 10.00118, DF 1, significance 0.00156
Note: For two firms the data could not be obtained.
Source: 1995 study

4.2.2.2 Size of firms

The assumption that smaller firms are less likely to apply for bank loans than larger firms has been confirmed, as microbusinesses (under 5 employees) in the 1995 survey were least likely to apply for a bank loan. This supports the hypothesis that there may be some self-selection among this group of firms (Figure 4.2). Due to the high level of collateral demanded and high interest rates charged, some of the microenterprises may have recognised that they either would not have a chance to obtain a loan or would not be able to meet the loan repayments. Another explanation may be that microfirms, due to the small amounts of total capital required by them, have the possibility of obtaining enough funds through personal loans, which are easier to access than business loans. However, those microenterprises that applied for a bank loan were indeed quite successful: 62 per cent of microfirms obtained bank finance, which was a higher proportion than those in the 6-20 employment size group, only 48 per cent of which were successful. It might be that in the case of microenterprises the private assets of the owner (e.g. his house) are sufficient as collateral, whereas such securities might not be enough to cover the amount sought by slightly larger firms. Case study firms 1 and 4 for example, employing eight and fifteen persons in 1995 (including two owners) were unsuccessful in attracting a loan from a bank because of insufficient collateral. In the first case, hand based production methods are used within the firm, therefore no machines are available that could be used as collateral. The private car provided not enough value to serve as collateral and the private house could not be used due to government plans to build a highway straight through the house (which existed for the last 30 years without anything ever happening). Case 4 used machines for production. However these were tailor-made and would not be sellable on the market, hence not acceptable as collateral. By comparison, case 3 (employing 15 persons in 1995) provided the private house as well as western machinery (which they intended to buy with the loan) as collateral and did received a loan in 1991. Nevertheless, as expected, the most successful firms in the 1995 study were the largest firms; 75% of those who applied for bank finance actually obtained it.

Figure 4.2: Size of firms in number of employees by attempt to obtain debt finance



Chi-square Pearson: value 21.57238, DF 3, significance 0.00008
Source: 1995 study

4.2.2.3 Year of the loan application

Evidence from the case study firms does not indicate any support for the hypothesis that debt finance was more easily obtained in the early years of transformation (1990/91) than in the following years (Bearing in mind that the data from the case study interviews is not representative.). Data about the year in which the firms applied reveals that the number of loan applications did stay more or less the same between 1991 and 1995, with a slight increase in 1996 and 1997. None of the firms tried to access debt finance in 1990 (Table 4.1).

On the other hand, the result has to be analysed with caution, as the criteria for the case study firms to be selected was that they had applied for external finance. Moreover, the number of loan applications per year does not necessarily indicate the difficulties of Polish firms in accessing loan finance, as firms applying for the second loan are likely to find it easier to obtain it than those applying for the first time (see section 4.5.2 for more details). Furthermore, firms that were successful in raising debt finance, might have had the opportunity to grow, to accumulate assets, hence be able to provide more collateral for future loans. Case study firm 7 for example, secured a loan in 1991 which is ".. the reason that this firm is in such a good state." (Owner-manager of case 7).

Additionally, unsuccessful loan applications are more often reported from case study firms that applied between 1994 and 1997 than those that applied before. One explanation might be, that because of the more stabilised economy with decreasing inflation rates firms were more interested in long term investments, hence in the need of higher amounts and longer termed finance. The problem firms experienced in attracting long term finance appeared to be connected with collateral and the reluctance of banks to grant larger loans. Both case 2 and case 5, for example, intended to build production premises in 1997, but could not provide sufficient collateral to secure the loan. In the case of firm 5 the loan would have been accounted for about 80 per cent of the current value of the assets of the business. Firm 5 also mentioned that banks are not interested to grant loans for longer periods of time. In this case, the firm had asked for a loan for five years. According to case 7 (who had three bank loans in 1997 and a fourth under negotiation) banks usually give loans for up to two years.

Another reason why more loan applications were rejected in more recent years might be that bank became more careful with loan applications form very young firms, as these typically are considered as being more risky businesses than more mature firms. Case 5, for example, managed to access debt finance for the start up of the business in 1992, whereas case 4 was unsuccessful in obtaining during their first year of trading in 1994. The reason for the rejection of the application was insufficient collateral. In conclusion, the evidence given does not indicate whether or not access to debt finance has become more difficult for firms (may be with the exemption of very young firms, for which it does appear to have become more difficult). However, with more years in a market economy firms seem to show an increasing interest in larger and longer term

investment, but for which they might not be able to provide sufficient collateral and which banks are reluctant to grant.

Table 4.1: Year in which firms applied for loan finance - evidence from the case study firms

<table>
<tr><th>(year of start-up)</th><th>1990</th><th>1991</th><th>1992</th><th>1993</th><th>1994</th><th>1995</th><th>1996</th><th>1997</th></tr>
<tr><td>Case 1
(1982)</td><td colspan="6">No[1]
(short)</td><td></td><td></td></tr>
<tr><td>Case 2
(1990)</td><td></td><td></td><td colspan="2">Yes[1] Yes[1] Yes[1]
(all short)</td><td></td><td></td><td></td><td>No
(long)</td></tr>
<tr><td>Case 3
(1945)</td><td></td><td>Yes
(long)</td><td></td><td></td><td></td><td></td><td></td><td></td></tr>
<tr><td>Case 4
(1994)</td><td></td><td></td><td></td><td></td><td>No
(short)</td><td>Yes
(short)</td><td></td><td>Yes
(overdraft)</td></tr>
<tr><td>Case 5
(1992)</td><td></td><td></td><td>Yes
(start up)</td><td>Yes
(short)</td><td>Yes
(short)</td><td>Yes
(short)</td><td>Yes
(short)</td><td>No
(long)</td></tr>
<tr><td>Case 6
(1990)</td><td></td><td colspan="5">Yes
(short)</td><td>No</td><td></td></tr>
<tr><td>Case 7
(1986)</td><td></td><td>Yes</td><td></td><td></td><td>Yes</td><td></td><td colspan="2">Yes[1] Yes[1]
(all short)
Yes[1]
(medium)
Under [4]
negotiations</td></tr>
<tr><td>Total number of applications</td><td>0</td><td>2</td><td>2.5</td><td>2.5</td><td>3</td><td>2</td><td>3.5</td><td>5.5</td></tr>
<tr><td>Number of successful applications</td><td>0</td><td>2</td><td>2.5</td><td>2.5</td><td>2</td><td>2</td><td>2.5</td><td>4.5</td></tr>
</table>

Note:
1) The firm did not mention the exact year they applied for debt finance.
2) In cases where a two year period was given for the loan application, both years were given half of the application for the calculation of the total number of loan applications.
3) In cases where more than two years were given a period in which the loan application took place, the application has been excluded from the calculation for the total number of loan applications.
4) This loan application has been counted as "successful" in the calculation of the number of successful applications, because the bank appeared willing to give the loan.

4.2.2.4 Key points in section 4.2.2

- The majority of Polish firms applying for debt finance are growth orientated, hence are in need of external finance to develop their business.
- Some firms are also pushed towards external finance, as they need to invest in order to keep up with raising competition.
- The small and medium sized firms are more likely to apply for debt finance than microbusinesses (firms with 5 or less employees). However, those microenterprises that did apply were more successful in obtaining debt finance then slightly larger firms. The reason might be that the private assets of smaller firms present sufficient collateral, whereas such security might not be enough to cover the amount sought by slightly larger firms.

- With more years in a market economy firms show an increasing interest in larger and longer termed investments, but then find they can not provide sufficient collateral. Moreover, banks are reluctant to grant longer termed loans.

Table 4.2: Evidence from the case study firms with regard to their attempt to access debt finance

Case study firms	General situation of the firm (1997)	Attempts to access debt finance
Case 1 Started trading: 1982 Size 1995: 8 employees Business objective 1993/94: some growth Education of main owner: Specialist secondary school	Declining business because of increasing competition, decreasing demand and lack of financial means to invest in machines to change the production.	Applied for bank loan before 1995 • short term loan • unsuccessful due to insufficient collateral • production is hand based, therefore no machines available that could be used as collateral • private house can not be used as collateral due to governments plans to build a highway though it • car is insufficient as collateral for the loan
Case 2 Started trading: 1990 Size 1995: 26 employees Business objective 1993/94: some growth Education of main owner: Specialist secondary school	Growth orientated firm with many ideas to develop the company, however not the funds to put them into practise.	Received three bank loans between 1992-93 • provided machines as collateral • short term loans (up to one year) used as working capital Current situation(1997) • interested in loan finance for investments (to build production premises) • interested in raising 300,000 ZLP • has not enough collateral to get a loan from the bank
Case 3 Started trading: 1945 Size 1995: 11 employees Business objective 1993/94 survival, making acceptable living Education of main owner:: Secondary school	Firms that developed from using traditional production methods (mainly hand based and simple machinery) towards modern machinery. However, the firm is operating in a market with increasing competition which puts it in a difficult financial situation.	Received loan from western credit line via PBG bank in 1991 • provided private house and machines they intended to buy with the loan as collateral • the loan was used to buy machines from Denmark • the loan was taken over by PBG bank in 1991 • the loan was originally for four years and was later extended to 10 years

Table 4.2: Evidence from the case study firms with regard to their attempt to access debt finance (cont.)

Case study firms	General situation of the firm (1997)	Attempts to access debt finance
Case 4 Started trading: 1994 Size 1995: 15 employees Business objective 1993/94: definitely growth Education of main owner: University of other higher education	Firm consisting of seven partners (one of which is a company) with growing sales turnover. However, different views among the shareholders regarding the future development of the firms leads to inconstancy within the management.	Applied for a bank loan in 1994 • unsuccessful due to lack of collateral • the machined used for the production are tailor made and therefore not suitable as collateral Received bank loan in 1995 • even though they had not enough collateral to secure the loan • received loan because the main customer, who is one of the partners and owned by the bank to 60 per cent, guaranteed for the loan • short term loan Current situation (1997) • have an overdraft limit on their account • could have received a loan from STRUDER if the management of the firms would have agreed how much and in what to invest
Case 5 Started trading: 1992 Size 1995: 35 employees Business objective 1993/94: definitely growth Education of main owner: University of other higher education	Growth orientated firm that seems to be in a favourable market position, as they can afford to demand cash payment from their customers. Trade credit is only granted to very well known customers.	Received a bank loan at start up (1992) • provided private house as collateral Received a loan every years since start up • short term loan • to receive these loan was not problematic because the firm could provide enough collateral Current situation (1997): • have one credit which was used to buy car • the firm is interested in a five year loan to buy production premises • the loan would account for about 80 per cent of the current value of the business • the banks are unwilling to give a loan for such a long time • in addition, the firm has problems to provide enough collateral

Table 4.2: Evidence from the case study firms with regard to their attempt to access debt finance (cont.)

Case study firms		General situation of the firm (1997)	Attempts to access debt finance
Case 6 Started trading: Size 1995: Business objective 1993/94: Education of main owner:	 1990 70 employees definitely growth Specialist secondary school	Prosperous and growth orientated firm. Sough external finance because the owner-manager had planned a large investment and expected the tax office to be surprise about the financial resources of the firm. In other words, in this case external finance was sought to cover unreported profits.	Received a bank loan before 1995 • provided cash as collateral • credit for 3 months Applied for a EU loan via a Polish banks in 1996 • attractive as interest rates are 10 per cent lower than loans from banks • unsuccessful, mainly due to the business plan required (too expensive) • the firm also wanted to use the loan for another investment than outlined in the plan
Case 7 Started trading: Size 1995: Business objective 1993/94: Education of main owner:	 1986 51 employees definitely growth University of other higher education	Firm producing high quality products for a small market with strong competition from foreign companies. Because of this and constant changes in the market, the firm needs to invest on a regular basis to stay competitive.	Received a loan from western credit line via PBG bank in 1991 • had to provide everything they had as collateral Received loan from STRUDER in 1994: • part of the funds were given as a grant Current situation (1997): • 12-13% of overall turnover per years are credits • have loans from 3 banks • the loans are for up to 2 years • collateral accepted by the banks are machines, houses, cars and sometimes raw materials • under negotiations for a further bank loan (Banks appears willing to give the loan)

Note: Some of the data is from the 1995 study.

4.2.3 Analysis of firms that are willing to consider external equity

In order to find out whether firms in Poland might be attracted to venture capitalists if such supply were available, the characteristics of firms surveyed in 1995 that showed an interest in external equity were analysed. Only those 240 firms that expressed an interest in raising additional finance were included in the analysis. Venture capitalists, both informal and formal, are attracted by firms with rapid growth prospects and that are able to produce a high rate of return on investment. They therefore need to be convinced that the owner-manager is be able to realise this expectations. In fact, the ability to manage the business is reported to be one of the key factors in the investment decision of venture capitalists (Harrison & Mason 1995, Boocock et al. 1995). Mason & Harrison (1994) note the lack of confidence in the entrepreneur to be the most significant reason for rejecting investments opportunities by business angels. The judgement whether or not an owner-manager is capable of managing the firms certainly depends on the personal impression he or she makes on the venture capitalist. However, the background of the owner, the level of education and former work experience, might influence that judgement.

The motivation of the owner manager to start the business is likely to be of relevance for the acceptance of venture capital, as for example owners prioritising independence are unlikely to be willing to share the ownership of the firm. However, firms might also be pushed towards the acceptance of venture capital because of difficulties to tap bank finance. In western countries venture capital typically is viewed by many SMEs as source of the last resort which will only be considered should other sources of debt finance not be accessible (Binks et al. 1990, Harrison & Mason 1995). Therefore, one could expect that firms which received a loan from a bank or another provider of debt finance would reject the idea of external equity. However, it might even be of more importance whether or not the development of the firm is constrained or held back by a shortage of finance, as this indicates more precisely the actual need of the firm to raise funds. Moreover, the amount of finance sought by firms might also contribute towards their interest in equity finance since it appears that firms experience more difficulties in raising larger amounts of finance, mainly because of difficulties in providing sufficient collateral.

Consequently, the analysis will examine the following characteristics of the owner-managers as well as firm related factors with regard to the interest of firms in external equity:

Characteristics of the owner-manager:

1. The growth orientation of owner-manager.
2. The background of the owner-manager (level of education and work experience).
3. The motivation of the owner-manager to start the business.

Firm level characteristics:

1. The profitability of the firm.
2. The possibility of the firm to access debt finance.
3. The extent to which the shortage of finance influences the development of the firm.
4. The amount of finance sought by the firm.

4.2.3.1 Growth orientation of owner-managers

Interestingly there is no significant difference between growth and non-growth oriented firms with respect to their willingness to consider external equity as a source of additional finance. 65 per cent of firms that aimed to grow in the next 12 month claimed to be interested in external equity compared with 70 per cent of firms that did not aim to grow. This might indicate that firms generally find it rather difficult to obtain debt finance, so that even firms that are not interested in growth but in defining their goals as making an acceptable living would consider external equity. This also includes firms that are struggling to survive, which are unlikely to be of interest for potential venture capitalists. Case study firm 1 for example, showed no interest in external equity when questioned in 1995 (1995 study), even though they had been unsuccessful in raising loan finance from their bank. In 1997, however, the owner-manager indicated an interest in venture capital, probably because the business is declining and an equity partner was seen as a potential saviour of the firm.

Nevertheless, growth oriented firms in the 1995 study showed a stronger interest in external equity than those with other business objectives (21 per cent of growth firms were definitively willing to consider external equity compare to only 9 per cent of firms without growth ambitions). Moreover, the majority of firms (90 per cent) were growth oriented in the first place and half of the 16 firms that did not aim to grow in the next 12 months claimed to be aiming for long-term growth. Looking at the growth actually achieved by firms in terms of sales turnover at the end of 1994 compared with 1993, it is encouraging to see that the majority of firms (74 per cent) increased their sales turnover in 1994. It seems that Polish firms are not only willing to grow but in fact are able to do so, and quite considerably. Therefore, Polish SMEs could be of interest for venture capitalists.

On the other hand, evidence from the case study interviews suggest that firms, even though growth is an important business objective, will be less interested in external equity as soon as they are able to access sufficient finance through other sources. Out of the four of the case study firms which indicated a definite interest in growth for 1993/94 in the 1995 study and which were still growth orientated when interviewed in 1997, only one firm (case 7) showed an interest in external equity in 1997. Two of the other firms expressed no need for external equity. One of them could generate enough internal funds, the other enjoyed an overdraft limit on their bank account and could have received a loan from STRUDER, if the management could have decided on how to invest the funds. In other words, the relatively high level of interest in external equity in this Polish sample of manufacturing firms appears to reflect the greater difficulties they experience in raising loans and other forms of finance compared with UK firms rather than a higher level of interest in venture capital per se.

4.2.3.2 Background of main owner (level of education and work experience)

Analysis of the 1995 survey shows no difference between the level of education of owner-manager nor their professional background with regard to their interest in external equity. However, it is encouraging that the level of education of Polish entrepreneurs is high in general, with 50 per cent of entrepreneurs having a University or other higher education. These findings are supported by a study by Erutku & Vallee (1997) who notes that 65 per cent of Polish owner-managers in his sample of 48 firms had completed their college education and that Polish entrepreneurs in general tend to be more educated then their American counterparts.

Regarding former work experience owner-managers come mainly form a technical background (50 per cent), e.g. have been an engineer before starting the own firm, or used to be a craft or skilled tradesman (23 per cent), for example a printer or carpenter. Therefore it might be, that whilst very capable of manufacturing the product, the owner-manager could be lacking marketing skills, an allegation which has been supported by further analysis. Information about the domestic market are mainly gathered through existing customers and/or informally from other businesses or colleagues in the same industry (64 per cent and 50 per cent respectively, where managers could cite up to three sources of information). To promote their products only 48 per cent of firms interested in external equity make use of advertisement and even fewer firms (20 per cent) produce any kind of sales brochures. These finding fit with those of Erutku & Vallee (1997) who notes that most Polish owner-manager '... do not know what marketing is, nor are they aware of the role that it could play in a business development strategy.' The lack of marketing know-how is not surprising considering the fact that none of that was needed in the former centrally planned economy, where the shortage of productive resources was the main problem, not a lack of demand or strong competition. Policy measures undertaken to overcome this deficit were not sufficient, partly because of the lack of suitable training arrangements as well as for technical and financial reasons (OECD 1996a). Other forms of marketing assistance, e.g. from business support organisations or from local/national authorities, was also lacking as 90 per cent of firms interested in external equity stated that they never received any external assistance for marketing. This certainly is a weak point from the perspective of any potential provider of external equity. However it also could be the base for a good working relationship should the venture capitalist be in the position to contribute marketing knowledge to the firm.

4.2.3.3 Motivation of owner-managers to start the business

The main reasons for starting businesses by surveyed managers were to seek self-fulfilment or independence (84 per cent of respondents) as well as to improve living standards or to increase income (62 per cent of respondents). However no difference could be found between founders with different motivations for starting the business with regard to their interest in external equity (Table 4.3). The reason is probably that over half of the respondents (53 per cent) mentioned both reasons as motivation for setting up their own business. This could indicate that while wanting to own the business the wish to increase the current living

standard is strong enough to accept sharing the ownership of the business, especially considering the lack of alternative sources of finance.

Evidence from the case study interviews confirms this suggestion. Out of the five firms that quoted "to improve living standards / to increase income" as their main aim for starting up the company, three did not expressed any interest in external equity. All of these firms had been able to access debt finance. The most often quoted reasons for being reluctant were the fear of the owner(s) to lose total control over the business operations. Out of the two firms that were interested in venture capital, one is declining and could not access any bank loan, therefore is desperate for funding (Case 1). The other one could access debt finance, however has to invest on a constant basis as the company operates in a changing market to invest in order to keep up with the competition (Case 7). In other words, this firms is more or less being pushed into the acceptance of external equity. Following this argument one would expect the interest of Polish firms in venture capital to decrease should bank finance or any other kind of debt finance become more easily obtainable in the future. Therefore, this factor has to be taken into account in the setting up of systems or policies aiming to improve the supply of venture capital to Polish SMEs.

Table 4.3: Reason for starting the business by willingness to consider external equity

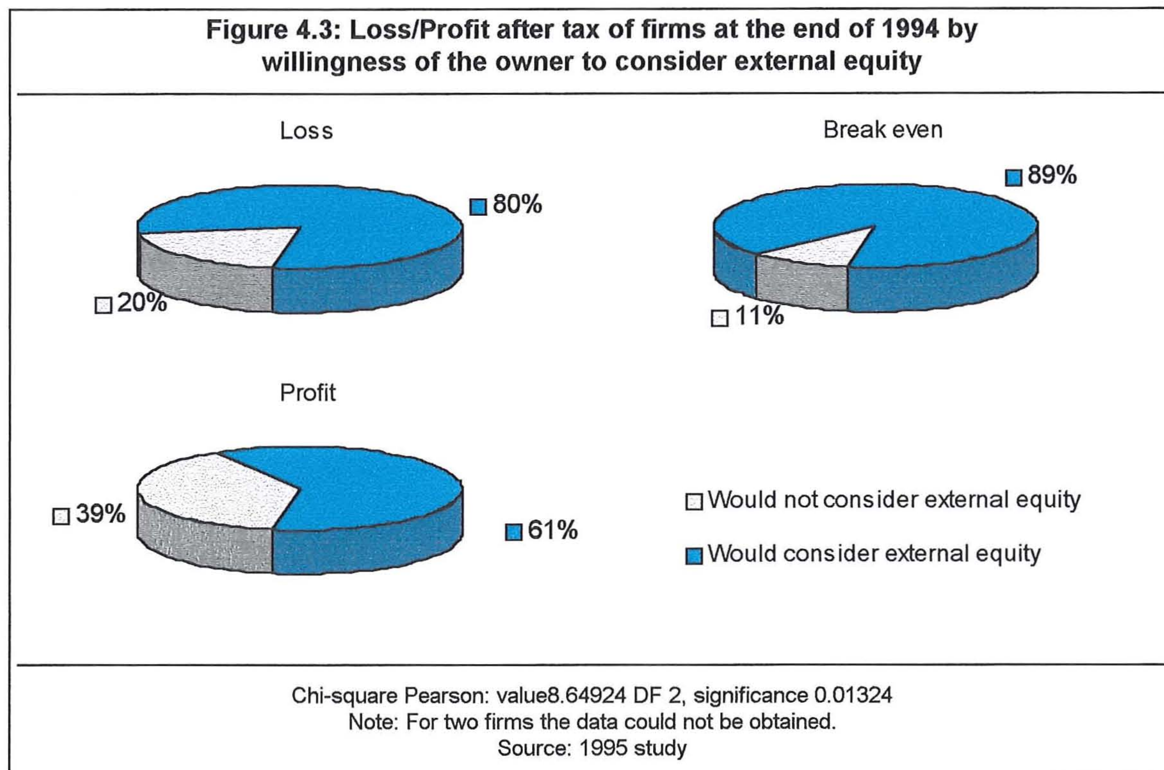
	Would not consider external equity		Would possibly consider external equity		Would definitely consider external equity		Total number of firms	
Reasons given	No	%	No	%	No	%	No	%
Seek independence or gain self-fulfilment	67	34	94	47	38	19	199	100
Improve living standard or increase income	53	36	69	47	25	17	147	100
Alternative to unemployment or family tradition or imitation of other entrepreneurs	27	33	40	49	14	18	81	100
Seek independence or go self-fulfilment **and** improve living standard or increase income	43	34	61	48	22	18	126	100

Source: 1995 study
Note: Manager could give up to three reasons for starting a business

4.2.3.4 Profitability of firms

As it appears from the above that difficulties in accessing debt finance constitute a push factor towards venture capital for Polish SMEs, it is not surprising that firms that made a loss in the financial year ending 1994 showed a higher acceptance of external equity as a possible source of finance then those ending up with a profit (80 per cent and 61 per cent repetitively - Figure 4.3). This is understandable, as loss making firms are more likely be dependent on external finance to keep the business going than those which are profitable, hence have more internal funds at their disposal. However this does not limit the scope for

Figure 4.3: Loss/Profit after tax of firms at the end of 1994 by willingness of the owner to consider external equity



Chi-square Pearson: value8.64924 DF 2, significance 0.01324
Note: For two firms the data could not be obtained.
Source: 1995 study

external equity provider, considering the fact that the majority of the firms that were interested in raising additional finance (82 per cent) did end the year 1994 with a profit

4.2.3.5 Possibilities for firms to access debt finance

Interestingly, whether or not a firm had been successful in raising a loan or not doesn't influence their interest in external equity. This might indicate that firms that received finance did not obtain enough finance. Indeed 56 per cent of these firms were still trying to raise additional finance of ZLP 100,000 and more. Case study firm 7 for example, even though very successful in raising debt finance (12-13 per cent of the overall turnover per year are financed with credits) had thought about accessing external finance, as they needed to invest on a constant basis to keep up with the competition in the market.

Another explanation for the interest in external finance of firms that accessed debt finance might be that the loan they did obtain since start up was short-term and that they are now in the need of another round of financing. It is also possible that they are now looking for long-term finance which they might find difficult to receive from banks, as experienced by two of the case study firms (Case 2 and case 5). On the other hand, both firms were not interested in venture capital. Case firm 5 generates enough internal funds and firm 2, even though in need of long term external finance, does not want to share the ownership of the firm with another partner. One reason is that members of the owners family are working within the company and that he feared that a new partner might disagree with this. Following these arguments, it appears that not the fact whether or not the firms could access debt finance is important towards the acceptance, but more whether or not the firms could raise sufficient funds internally.

In the case of the firms that tried to access debt finance but have not been successful (of which there were 57 in the survey), it is important to investigate the reason. For example, firms that have been denied funding for reasons that are connected with the viability of the firm or the project in question would certainly not be able to attract any source of equity. However, the survey showed that firms were mainly denied finance because of insufficient security or collateral (46 per cent) or could not accept the loan due to excessive interest rates (39 per cent). Further analysis even showed that the majority of these firms (77 per cent and 91 per cent respectively) did indeed realise a profit at the end of 1994 (Table 4.4), so were not failing to raise debt finance because of this factor.

Table 4.4: Firms that not been successful in obtaining a loan by profit/loss after tax at the end of 1994

	Loss		Break even		Profit		Total number of firms	
	No	%	No.	%	No	%	No	%
Collateral	5	19	1	4	20	77	26	100
Interest	1	4.5	1	4.5	20	91	22	100
Other	-	-	-	-	9	100	9	100
Total number of firms	6	10	2	4	49	86	57	100

Note: For seven firms the data could not be obtained.
Source: 1995 study

4.2.3.6 Shortage of finance for the development of firms

As expected, firms that are definitely constrained by a lack of finance expressed a stronger interest in external equity than those that were not at all or only to some extent constrained (Table 4.5). Nearly 30 per cent of firms that describe the development of their firms as clearly constrained by lack of finance would definitely consider venture capital compared to only 12 per cent of firms that were not at all or only to some extent constrained by a lack of finance. In other words, in an environment of limited access to debt financing, the lack of finance of Polish firms constitutes a negative push factor towards external equity.

Table 4.5: Firm's development constrained by lack of finance by willingness to consider external equity

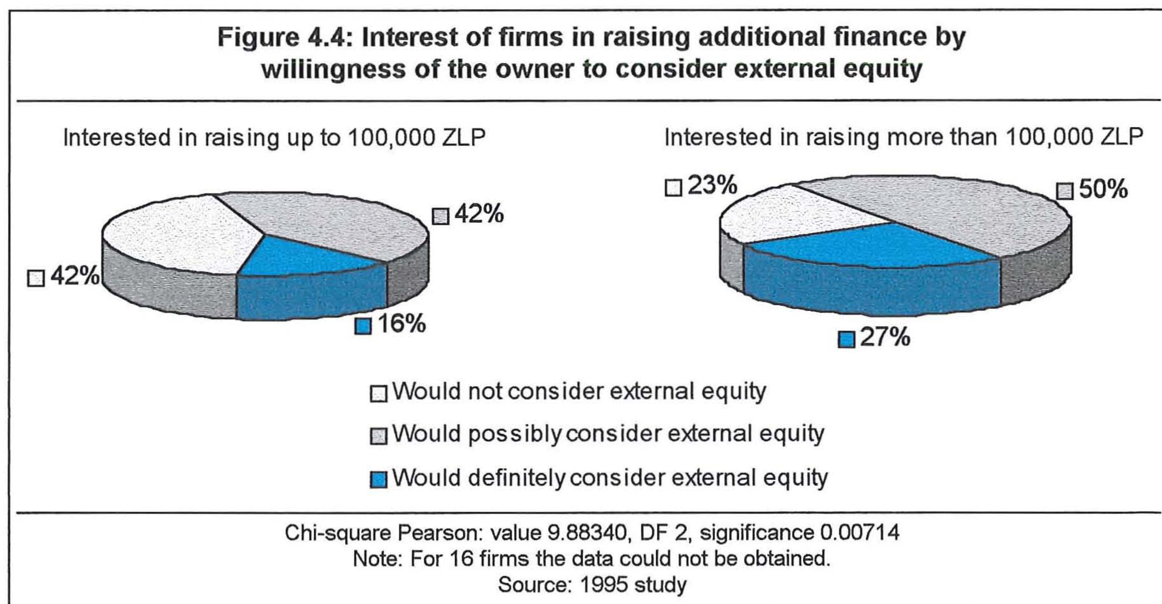
	Would not consider external equity		Would possibly consider external equity		Would definitely consider external equity		Total number of firms	
Constrained by lack of finance	No	%	No	%	No	%	No	%
not at all / to some extent	46	35	69	53	16	12	131	100
definitely	36	33	41	38	31	29	108	100
Total number of firms	82	100	110	100	47	100	239	100

Chi-square Pearson: value 11.02271, DF 2, significance 0.00404
Note: For one firms the data could not be obtained.
Source: 1995 study

4.2.3.7 Interest in additional finance

Firms interested in raising larger amounts are significantly more willing to share the ownership of the company, in other words to consider external equity (Figure 4.4). 77 per cent of firms seeking to raise more than 100,000 ZLP showed a positive attitude towards external equity with 27 per cent being definitively interested. In comparison, firms seeking up to 100,000 ZLP were less willing to consider external equity, yet still showed a high level of interest. More than half of these firms (58 per cent) would consider venture capital with 16 per cent mentioning a definitive interest. An explanation might be that firms seeking larger amounts can't deliver the collateral necessary to obtain such amounts of debt finance from banks, whereas securities such as cars, the private house etc. might be sufficient to raise smaller amounts of finance. It could also be that firms seeking larger amounts of finance need these for long term investment and that external equity is considered due to the lack of available long term bank finance.

Figure 4.4: Interest of firms in raising additional finance by willingness of the owner to consider external equity



Chi-square Pearson: value 9.88340, DF 2, significance 0.00714
Note: For 16 firms the data could not be obtained.
Source: 1995 study

4.2.3.8 Key points in section 4.2.3

- The majority of firms interested in venture capital ended 1994 with a profit and increased their turnover in 1994 compared to 1993, on average by 25 per cent (median).
- Polish owner-managers in general are well educated.
- Owner-manager come mainly from a technical background or used to be a craft or skilled tradesman. They show a lack of marketing know-how, which can be a weak point from the perspective of potential equity provider.

It is therefore fair to argue that Polish firms, in terms of their growth ambitions, their growth potential and their personal ability could well be of interest to informal venture capitalists, especially to those that could provide marketing knowledge to the firm.

- Even though owner-managers seek independence, the wish to increase the current standard of living or the need to invest because of increasing competition is strong enough to accept sharing the ownership of the business in a large proportion of firms.
- Former success in raising debt finance does not necessarily influence the interest of owner-managers in external equity, probably because firms had only obtain short term finance and became more interested in longer term loans which banks do not provide. However, as soon as the firms receive sufficient debt finance, their interest in venture capital decrease.
- Firms were denied debt finance mainly because of insufficient collateral or excessive interest rates required by banks. The majority of these firms did however realise a profit a the end of 1994. Banks are not financing profitable firms due to conservative lending and high interest rates.
- Firms interested in raising larger amounts are more interested in venture capital than firms interested in raising smaller amounts.
- Two thirds of firms interested in external equity are actually constrained in their development by a shortage of finance.

It would appear that from the small business owner point of view, a better venture capital market in Poland can help overcome financial constraints which hinder the development of the firms, without them having to provide extensive securities. However, the majority of firms started their business in order to stay independent and the majority of firms willing to consider external equity were definitely constrained by external finance, which constitutes a negative push factor. Therefore, one would expect the interest in venture capital to decrease as soon as the collateral requirements for debt finance are lowered and longer termed debt finance become more easily available from banks.

Table: Table 4.6.: Evidence from the case study firms with regard to their interest in external equity

Case study firms		Motivation for starting the business	General situation of the firm (1997)	Success in accessing debt finance	Interest in external equity
Case 1 Business objective 1993/94: Education of main owner: Background of main owner:	 some growth Specialist secondary school craft/skilled tradesman	to improve living standards / to increase income	Declining business because of increasing competition, decreasing demand and lack of financial means to invest in machines to change production.	Did not receive any debt finance.	YES They would like to access external equity, however do not know how they could do this.
Case 2 Business objective 1993/94: Education of main owner: Background of main owner:	 some growth Specialist secondary school craft/skilled tradesman	1) to improve living standards / to increase income 2) family tradition 3) to seek independence / autonomy	Growth orientated firm with many ideas to develop the company, however not the funds to put them into practise.	Received three short term bank loans between 1992-93	NO The owner does not want to share the firm with another partner. One reason for this is that members of the owners family are working within the business, and he would be afraid that a new partner would want to change the situation.
Case 3 Business objective 1993/94 Education of main owner: Background of main owner:	 survival, making acceptable living Secondary school craft/skilled tradesman	1) family tradition 2) to seek independence / autonomy	Firms that developed from using traditional production methods (mainly hand based and simple machinery) towards modern machinery. However, the firm is operating in a market with increasing competition which puts it in a difficult financial situation.	Received long term loan in 1991.	NO The owner has no interest in external equity.

Table: Table 4.10.: Evidence from the case study firms with regard to their interest in external equity (cont.)

Case study firms		Motivation for starting the business	General situation of the firm (1997)	Success in accessing debt finance	Interest in external equity
Case 4 Business objective 1993/94: Education of main owner: Background of main owner:	 definitely growth University of other higher education Technical	1) to improve living standards / to increase income 2) to seek independence / autonomy 3) to gain self-fulfilment	Firm consisting of seven partners (one of which is a company) with growing sales turnover. However, different views among the shareholders regarding the future development of the firms leads to inconsistency within the management.	Received short termed bank loan in 1995. Currently have an overdraft limit on their account Could have received a loan from STRUDER if the management of the firms would have agreed how much and in what to invest	NO The firms does not need any external equity. Moreover, the current partners would be afraid that an increase in external equity might lower their significance in the firm.
Case 5 Business objective 1993/94: Education of main owner: Background of main owner:	 definitely growth Technical University of other higher education	to improve living standards / to increase income	Growth orientated firm that seems to be in a favourable market position, as they can afford to demand cash payment from their customers. Trade credit is only granted to very well known customers. I	Received a bank loan at start up (1992) Received a loan every years since start up The firm is now looking for a larger and longer term loan which the banks are unwilling to give.	NO The owner had bad experiences with a partner in the past, as the partner had a different view about how to run the company.

Table: Table 4.10.: Evidence from the case study firms with regard to their interest in external equity (cont.)

Case study firms		Motivation for starting the business	General situation of the firm (1997)	Success in accessing debt finance	Interest in external equity
Case 6 Business objective 1993/94: Education of main owner: Background of main owner:	 definitely growth Specialist secondary school Technical	1) to gain self-fulfilment 2) to seek independence / autonomy 3) to improve living standards / to increase income	Prosperous and growth orientated firm that appeared to have sough external finance only to cover illegal activities. The owner-manager had planned a large investment and expected the tax office to be surprise about the financial resources of the firm.	Received a short termed bank loan before 1995	NO There is no need for external equity in the firm.
Case 7 Business objective 1993/94: Education of main owner: Background of main owner:	 definitely growth University of other higher education Academic	1) to improve living standards / to increase income 2) to seek independence / autonomy 3) family tradition	Firm producing high quality products for a small market with strong competition from foreign companies. Because of this and constant changes in the market, the firm needs to invest on a regular basis to stay competitive.	Received a loan in 1991 Received loan from STRUDER in 1994: Currently, enjoy two short term and one medium term bank loan.	YES They had thought about external equity, even about listing at the stock market. However, their turnover is too low at present to be able to list on the stock market. To achieve sufficient turnover, they would need external support.

Note: Some of the data is form the 1995 study.

4.3 Need for further finance

In order to improve the financial market for SMEs effectively, it is important to understand both the financial needs and the characteristics of small firms. Moreover, the expectations of SMEs with regard to external finance have to be taken into account, as difficulties in accessing external finance reported by small business owner might partly exist because of unrealistic expectations of the owner-manager. Therefore, this section will analyse the characteristics (such as age, sector, size and growth orientation) of firms interested in additional finance, as well as the terms and conditions (e.g. amount, repayment period and interest rates) under which those firms would be willing to accept external finance.

The basis for this section are the 240 firms of the 1995 survey (80 per cent) that showed an interest in raising additional finance, of which 50 per cent expressed a strong interest. However, no difference could be found between firms that were possibly interested in raising additional finance and those that were definitely interested with regards to the amount of finance required. Over half of the firms (57 per cent) were interested in raising amounts up to 100.000 ZLP where as about a quarter of firms would have preferred to borrow more than 300.000 ZLP (Table 4.7). The typical amount sought was 100.000 (median), the lowest amount required was 5.000 ZLP and the highest amount was 11.000.000 ZLP.[7]

Table 4.7 Interest in additional finance in ZLP

	Number of firms	Percentage of firms
up to 50,000 ZLP[8]	65	28.9 %
over 50,000 ZLP up to 100,000 ZLP	63	28.0 %
over 100,000 ZLP up to 300,000 ZLP	42	18.7 %
over 300,000 ZLP	55	24.4 %
Total number of firms	225	100 %

Source:1995 study

[7] 15 firms out of that group had to be excluded from the analysis as no data about the amount of finance they would have liked to raise is available.

[8] ZLP 50,000, ZLP 100,000 and ZLP 300,000 are the quartiles of the frequency distribution of additional finance sought by Polish SMEs.

4.3.1 Characteristics of firms that are interested in additional finance

4.3.1.1 Age of firms

Analysis of the 1995 survey showed no difference between firms that had started trading before the political changes in summer 1989 and those that had started trading after summer 1989 with respect to their demand for additional finance per employee[9].

This would be somewhat surprising in the case of more mature market economies, where one would expect the older firms to have less demand for additional finance per employee since they have had the opportunity to accumulate capital over an extended period of time. However, in Poland the situation is somewhat different. The growth of small firms was limited under communism and external finance for SMEs only became more accessible in the 1980s in the form of foreign start up capital (Grabowski et al. 1992). Therefore, Polish firms that started trading before 1989 had no more chance to accumulate assets than those that started later. Moreover, firms that stated trading under communism had to adapt to the new economic environment after 1989 in terms of their approach in running the business (from production orientation towards consumer orientation). Therefore, it might indicate that the resources of the older firms had already been used for adjustments necessary to adapt to the new market environment.

4.3.1.2 Sector

Smallbone et al 1996 already stated that there were sectoral variations regarding the financial needs of firms. The median capital sum sought by firms in the food processing sector (ZLP 200.000) was twice the level of the median of the sample as a whole. In fact, the minimum and maximum capital sum required by SMEs in the food sector were on a higher level that those of the firms in the other sectors (Table 4.8).

Table 4.8: Interest in additional finance in ZLP by sector

	Median	Mean	Minimum	Maximum
Food processing	200,000	791,455	20,000	11,000,000
Engineering	100,000	252,158	5,000	2,000,000
Clothing	100,000	292,624	7,200	3,000,000
Furniture	100,000	226,364	10,000	2,000,000
All sectors	100,000	388,112	5,000	11,000,000

Source: 1995 study

To eliminate possible effects the firm size might have on the capital sum required, the amount of additional finance per employee required was calculated for each sector (Table 4.9). There still appeared to be a very significant difference between the sectors. 65 per cent of the SMEs in the food processing sector would have liked to raise more then 8.333 ZLP per employee, compared to 60 per cent of firms in the furniture sector,

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[9] The amount of additional finance per employee required was used to eliminate possible effects the firm size might have on the capital sum required

50 per cent in the engineering sector and only 30 per cent in the clothing sector (χ^2-test = 0.00084). This reflects the high investment costs that are typical of the food processing sector due to the expensive machinery needed, whereas the clothing sector is typically more labour intensive, particularly given the cut make and trim (CMT) nature of much of the activities in the case of surveyed firms (Smallbone et al 1996).

Table 4.9: Interest in additional finance per employee by sector

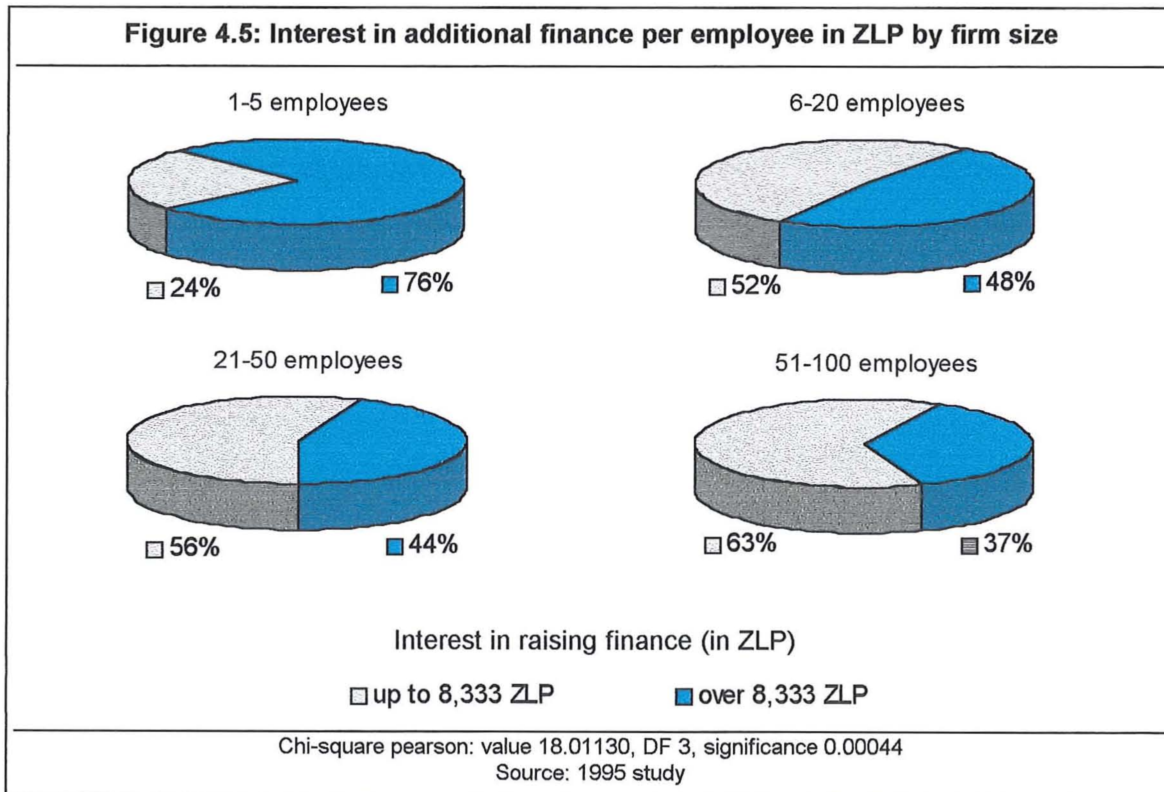
	up to 8,333 ZLP[10]		over 8,333 ZLP		Total number of firms	
	No	%	No	%	No	%
Food processing	19	35	36	65	55	100
Engineering	29	50	29	50	57	100
Clothing	40	70	17	30	57	100
Furniture	22	40	33	60	55	100
Total number of firms	110	49	115	51	225	100

Chi-square pearson: value 16.673235, DF 3, significance 0.00084
Source: 1995 study

4.3.1.3 Size of firms

Looking at the amount per employee required by the firms, it appeared that it was mainly the microenterprises that needed the highest amounts. 76 per cent of the firms with 1-5 employees would have liked to raise more then 8.333 ZLP[10] per employee compared with between 37 to 48 per cent of the other size groups (Figure 4.5).

Figure 4.5: Interest in additional finance per employee in ZLP by firm size



Chi-square pearson: value 18.01130, DF 3, significance 0.00044
Source: 1995 study

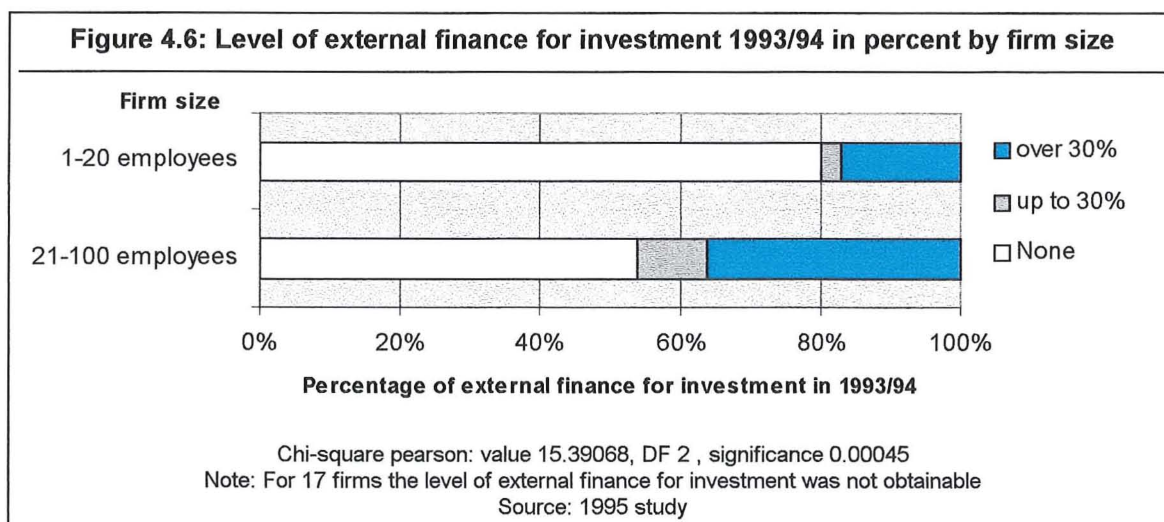
One explanation might be that, as mentioned earlier on, microenterprises were least likely to apply for a bank loan in the first place, hence were among those firms that received the lowest level of external finance both for the start up of the business as well as for investments in 1993 and 1994 (Table 4.10 and Figure 4.6). In addition, microenterprises were less successful in growing in terms of sales turnover than the larger firms. More than half of the firms with 1-5 employees (56 per cent) reported that the value of sales decreased in 1994 compared with 1993, whereas 70 to 90 per cent of firms with 6 and more employee said it had increased. Therefore it was even more difficult for microenterprises to generate funds for investment, which may help to explain why they invested significantly smaller amounts in the years 1993 to 1994 than larger firms, even when standardised by the number of employee. The majority of firms with 1-5 employee (64 per cent) invested less then 2,500 ZLP[11] per employee compared to 36 per cent of firms with 51-100 employee (χ^2-test = 0,03263). This suggests that the demand for higher amounts of additional finance among microenterprises exists due to the low level of internal sources available for investments. This is also supported by the high percentage of microenterprises (32 per cent) claiming that their technical standard is lower than that of their competitors, compared with 9 to 19 percent of firms with 6 and more employee (χ^2-test = 0.02934).

Table 4.10: Main sources of capital at start up by firms size

Number of employees	Internal sources		External sources		All responses	
	No	%	No	%	No	%
1-5	73	89	9	11	82	100
6-20	91	89	11	11	102	100
21-50	72	75	24	25	96	100
51-100	66	71	27	29	93	100
All responses	302	81	71	19	373	100

Note: Each manager was able to identify up to 3 main sources of capital at start up
Source: 1995 study

Figure 4.6: Level of external finance for investment 1993/94 in percent by firm size

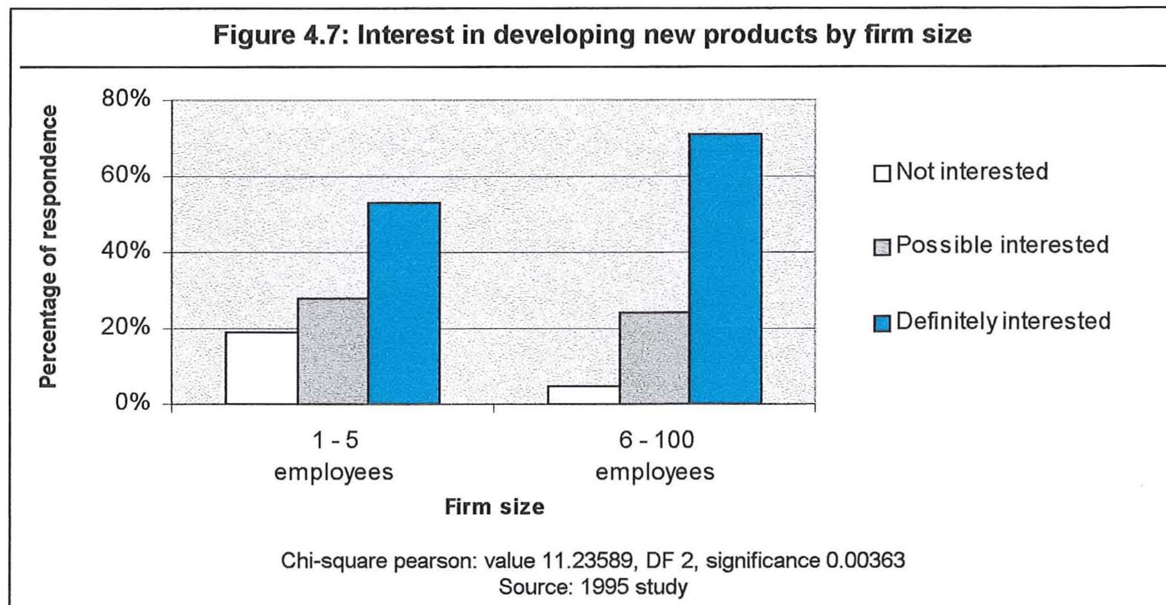


Chi-square pearson: value 15.39068, DF 2 , significance 0.00045
Note: For 17 firms the level of external finance for investment was not obtainable
Source: 1995 study

[10)] 8.333 ZLP per employee is the median amount of additional finance per employee required

As mentioned by Smallbone et al. (1996), the development of new products is important for firms to survive and grow in the face of increasingly competitive market conditions. Since financial resources are required to implement a strategy for innovation it is not surprising that firms that were more interested in developing new products required significantly higher amounts of additional finance then those that were less interested (χ^2-test = 0,02277). However when standardised by firm size no differences could be identified between the level of interest in product development with regard to the amount of additional finance required. The same phenomena appeared when the aim to grow in the next 12 months was compared with the need for additional finance. In other word firms that were less interested in product development and growth still needed as much funds as those firms that showed more interest. This suggests that the former had other reasons for the need of additional finance. As it was mainly the larger firms in the survey that showed a higher interest in the development of new products as well as in growth (Figure 4.7 and Table 4.11) the overall conclusion is that the larger firms in the study seem to need additional finance mainly for product development and growth whereas the microenterprises need part of the funds to raise their technical standard to that of their competitors, in other words simply to survive.

Figure 4.7: Interest in developing new products by firm size



Chi-square pearson: value 11.23589, DF 2, significance 0.00363
Source: 1995 study

Table 4.11: Growth an aim for the next 12 months by firms size

Number of employee	Growth is not an aim		Growth is an aim		Total number of firms	
	No	%	No	%	No	%
1-20	16	14%	100	86%	116	100%
21-100	6	6%	102	94%	108	100%
Total number of firms	22	%	202	%	224	100%

Chi-square pearson: value 4.28501, DF 1 , significance 0.03845
Note: In one case the data was not obtainable
Source: 1995 study

[11)] ZLP 2,500 is the median sum invested per employee of the firms that were interested in raising additional finance.

4.3.2 Terms and Conditions

As mentioned above opportunities for SMEs to access debt finance from banks are still limited, especially for long-term credits. However no evidence could be found from the 1995 survey that a demand for long-term credit exists among SMEs. Indeed only 44 firms out of the 225 that were interested in additional finance answered the question about the maturity period they would want provided a bank loan would be available. 23 of these 44 firms were interested in a period of between one and three years. 13 firms would have preferred a short-term loan with a maturity period of up to one year and the remaining 8 firms seek to borrow funds for more then three years.

On the other hand, as the economic situation in Poland became significantly more stable between 1995 and 1997, with inflation lowering from 27.8 per cent to 13.2 per cent (Gronkiewicz 1998, National Bank of Poland 1998), firms might have become more interested in longer term loans. This suggestion is supported by two of the case study firms that tried (unsuccessfully) to access long termed finance in 1997 in order to build production premises. One of these firms (case 5) required a maturity period of five years.

The majority of firms (77 per cent) were willing to accept nominal interest (i.e. not adjusted by the inflation rate) rates up to 23 per cent. The average rate managers approved was 12 per cent (median). Compared with the interest rates offered by commercial banks in 1995 these appear relatively low as the lending rates of the banks only started at 24 to 44 per cent, depending on the individual bank (National Bank of Poland - Annual Report 1995). However, these rates were for lowest-risk loans and referred to the interest rates charged to borrowers in good financial standing. In particular cases, depending on the level of risk involved, banks applied higher rates (National Bank of Poland - Annual Report 1995). Considering the high risks involved in lending to small and medium sized businesses, it is very likely that these higher rates would have been applied for the firms surveyed enterprises (Keasey 1993, Wyczanski 1993). Nevertheless, an inflation rate of 27.8 per cent in 1995 emphasises that small business owners have rather unrealistic expectations regarding the interest rate, as they seem not to realise that banks simply can not survive on negative real interest rates, as they are commercial businesses and, like every business, depend on profits in order to survive (For more information on interest rates see section 5.5.3).

4.3.3 Key points in section 4.3

- The typical amount sought by Polish manufacturing SMEs in 1995 was 100,000 ZLP (median).
- It appears that the resources of the older firms had been already used of adjustment necessary to adapt to the new market economy, as analysis of the 1995 survey showed no difference between firms that had started trading before the political changes in summer 1989 and those that had started trading after summer 1989 with respect to their demand for additional finance per employee.
- Firm seeking larger amounts of finance than the median amount were typically those of the food sector, probably because of the expensive machinery needed in this sector.

- Micoenterprises were typically more interested in raising higher amounts of finance per employee than larger firms.
- The larger firms in the study seem to need additional finance mainly for product development and growth, whereas the micoenterprises are in the need of additional external finance partly to raise their technical standard in order to survive in a market economy with an increasing level of competition and to compensate their lack of own resources.
- In 1995, no evidence could be found that a demand for long term debt finance exist among Polish SMEs. However, this might have change between 1995 and 1997, due to a increasingly stable market environment.
- Polish owner-managers seem to have unrealistic expectations with regard to the interest rates they would be willing to pay.

4.4 Consequences of not obtaining external finance and alternatives to external finance: Evidence from the case studies

A shortage of finance is reported to be the single most important source of failure of SMEs in the UK, an opinion which is shared by small business owners as well as the Official Receiver (Storey 1994). In Poland, due to the fact that the main sources of finance are internal resources, combined with a low average level of assets, the structure of SMEs is dominated by very small and financial weak enterprises (Slifirczyk 1992). It may be that businesses which can not access any external source of finance will become insolvent. However this does not mean that the shortage of external finance inevitably leads to business failure. Research undertaken by Leigh et al. (1991) and North et al. (1991) also points to the importance of a range of non financial adjustments undertaken by the small firm (regarding the market, the production process, labour issues and the organisation of the business) for the survival of SMEs. These imply the reemployment of human resources (human capital) as much as (or more) financial capital.

A survey of 900 SMEs in Sweden by Winborg & Landström (1997) analysed the measures undertaken by small business managers to meet the need for resources without using long-term external capital from institutional financiers. Winborg & Landström refer to these measures as "financial bootstrapping". In the researchers opinion financial capital as such is not important for the small business manager but rather the resources needed by the firm. As a consequence "entrepreneurship and small business management are very much about the 'creation' of resources." Thereby it is argued that different resources are more or less integrated in small firms, for example the social network is used to secure tangible and intangible resources from external parties (Winborg & Landström 1997). During the communist period in Poland, informal relationships were of particular importance for starting a business, as external sources of finance were hardly available. In fact, a significant number of firms starting trading in the 1980s without real capital. The critical factor in operating the firms successfully was more to establish business relationships with large state owned enterprises or local authorities, to receive orders or arrange contracts (Grabowski & Kulawczuk 1991a). In some case, the state even delivered the raw materials necessary for the production (Karwowska &

Mrozinska 1993). Other sources were, and still are, based on the price differences in Eastern and Western market, which are made used of by networks of small enterprises on both sides of the border of Poland (Karwowska & Mrozinska 1993). Considering the reluctance of formal providers of external finance to deal with Polish SMEs, informal networks are likely to be still of more importance for small firms in Poland when compared with their counterparts in more mature market economies. This is supported by the fact that Polish firms have to rely more on internal sources of finance and other personal (informal) networks, such as friends, to finance their businesses than SMEs in the UK (see section 3.4 for more details).

4.4.1 Bootstrapping measures applied by SMEs

The analysis of the data collected by Winborg & Landström (1997) revealed two main groups of "bootstrapping measures" used by surveyed firms, those with the aim of reducing the need for capital requirements and others with the aim to meet the need for capital. The ten bootstrapping measures most often used in both groups are listed below.

Ten bootstrapping measures most often used to minimise capital need:

1. buy used equipment instead of new — 78 per cent of respondents
2. use routines in order to speed up invoicing — 44 per cent of respondents
3. borrow equipment from other businesses for shorter period — 42 per cent of respondents
4. use interest on overdue payment from customers — 41 per cent of respondents
5. hire personnel for shorter period instead of employing permanently — 40 per cent of respondents
6. Use routines in order to minimise capital invested in stock — 39 per cent of respondents
7. Co-ordinate purchases with other businesses — 36 per cent of respondents
8. Lease equipment instead of buying — 33 per cent of respondents
9. Cease business relations with customers frequently paying late — 32 per cent of respondents
10. Offer same conditions to all customers — 30 per cent of respondents

Ten bootstrapping measures most often used for meeting need for capital requirements:

1. seek out best terms of payment possible with supplier/s — 74 per cent of respondents
2. withhold owner/manager's payment for shorter/longer periods — 45 per cent of respondents
3. deliberately delay payment to supplier/s — 44 per cent of respondents
4. obtain payment in advance from customers — 33 per cent of respondents
5. use owner/manager's private credit card for business expenses — 30 per cent of respondents
6. Obtain capital via manager's assignment in other businesses — 28 per cent of respondents
7. Obtain loan from relatives/friends — 24 per cent of respondents
8. Deliberately delay payment of value-added tax — 14 per cent of respondents
9. Obtain subsidy from Country Administrative Board — 9 per cent of respondents
10. Obtain subsidy form Country Labour Board — 8 per cent of respondents

(Source: Winborg & Landström 1997)

Applying this framework to the Polish case studies might give examples and an initial insight into strategies applied by Polish small business manager to survive without external finance. (Bear in mind that only firms that still exist had been interviewed.) The bootstrapping measures mentioned in the interviews are listed below, followed by a more in detail analysis of each case.

Bootstrapping measures used by Polish case study firms:

- dismissing of employees and using members of the family instead
- decrease in the profit margin
- tight cost management (what to buy and when)
- reinvestment of all firm profits
- looking for support from a foundation or institution (plan for the future - has not happened yet)
- flexibility with respect to investment opportunities

While these measures are used not only by Polish but also by SMEs in more mature market economies , some firms reported other steps undertaken in order to adjust to the special condition of an economy under transition:

- illegal activities to cope with rapidly changing regulations
- use of credits to cover unreported activities

Bootstrapping measures are certainly useful when external finance provided by formal providers is not available, as they help the firms to overcome resource based constrains. However, it is a diversion of management time and resources and might hinder the development of the business in the long term, for example in cases where the profit margin had to be decreased. Moreover, those measures that are of illegal character might put the existence of the firms on risk, especially if the firm is depended on not reporting some of the business activities. Some of the key informant interviews revealed that it is quite usual for small firms in Poland to hide part of their profits, in order to lower the amount of tax payable. In fact, the level of taxation is reported to be the main constrain in the development of Polish SMEs (Welter 1994, Smallbone et al. 1996). This might offer some scope for Polish policy makers to improve the financial situation of SMEs without actually offering financial support, e.g. by reviewing the current tax system. It is therefore encouraging that according to Piasecki et al (1998) the Polish system of taxation, and taxation rates, appear to move towards those adopted in the EU.

4.4.2 Bootstrapping: some case study scenarios

Case 1:

This firm was founded in 1982 by two partners and manufactures chairs. They specified a decrease in demand as their main problem, followed by delayed payments from customers. Being unsuccessful in raising bank finance combined with a cash-flow problem makes it impossible to invest in new equipment in order to change their range of production or to increase any marketing effort. The bootstrapping measures

the partners decided to take were to dismiss seven of his staff between 1995 and 1997, keeping only one full-time employee and relying on the partners wives to help out. However it is questionable whether this will help the firm to survive in the future as the firm is declining. In the 1995 survey the firm reported an after tax profit of more then five per cent of sale turnover whereas in autumn 1997 they described their profit margin as "quite low".

Case 2:
This partnership consists of two persons and started trading in August 1991, manufacturing kitchen furniture. They have been successful in obtaining three loans between 1992 and 1993 which have been used as working capital. However in 1997 when they planned to invest in land and to build premises for manufacturing (the current premises are rented), they could not access any bank finance due to the lack of collateral. They managed to buy the land from retained profits and are now searching for other sources of finance to construct the plant, e.g. a support foundation or institution (the owner did not mention a particular foundation or institution) who will support him to build the premises in 1998. In this case the lack of external finance did not put the existence of the firm at risk, which might be because the owners proved to be flexible as they took another investment opportunity that consisted of the purchase of two machines. The agreement included a supplier credit for 50 per cent of the price, whereas the other 50 per cent had to be paid in cash. Therefore, in this case, the bootstrapping measures consisted of searching for help from a support foundation as well as of flexibility with regard to investment opportunities.

Case 3:
The owner of this firm manufactures cookies and ice-cream and sells them to wholesale companies as well as to the public via a small retail shop. Although being successful in accessing western credit lines in July 1991, he had problems with importing the machines he bought with the loan from Denmark. By the time the machines arrived in Poland the Polish government, without any warning, had introduced a new custom law. According to the new law the small business owner had to pay 30.000 ZLP in custom tax, an amount which he could not provide. Therefore the custom officer 'arrested' the machines, meaning that the machine were located in the premises of the small firm, but not connected. The owner was not allowed to used them until custom tax had been paid. Having to pay interest without being able to increase profits by using the machines put the firms under tremendous financial stress. The owner tried to clarify that, as he had bought the machines before the new law had been introduced, it should not be applicable. He contacted several institutions, including the government, the custom office and the main custom office president. Even though he received letters saying that he would be right in principle, he was told that nothing could be done about it. Therefore he had to pay the tax. In March 1992 the owner informed the custom office that, as he was unable to pay the tax, he would send the machines back to Denmark. He transported the machines back to the harbour, but instead of sending them back to Denmark he hid them in the custom free zone. Two days later, on the 8 of March, was 'Woman Day', an event that is celebrated in Eastern European countries. Because of this event the customs officers were drunk and therefore less careful. The owner used this opportunity to transport the machines out of the custom free zone and back home without them noticing.

Being now able to use the machine made the firm profitable. In this case the owner was lucky that this illegal bootstrapping method was not discovered by the authorities. However valuable time was lost, as in 1992 large foreign companies entered the ice-cream market, significantly increased the competition. Even more seriously, one of the partners died during that period, probably because the episode was too stressful for him.

Case 4:
Seven partners established this firm in 1994, 6 natural persons and one firm. The main activity is the production of parts for hydraulic machines. Their loan application had been rejected but being lucky enough to have the shareholder firm as main customer (at start up as the only customer), the firm did not encounter any demand problems. Thus they were profitable and could invest all their profits in equipment and machinery. However, in their first year of existence they had to apply a strong financial discipline, in other words they had to control the purchases of the firm. This bootstrapping measure meant that every purchase had to be discussed with the financial director, whether it was necessary to obtain that item, whether it was possible and what would be the best time of the purchase. In 1995 they applied for a loan again, this time successfully.

Case 6:
Firm 6, a food producing company founded in 1990, is a somewhat a different case, as they are doing well and are not in the need for external finance. However, the owner applied for a 3 month bank loan to purchase an expensive machine and was successful, as he offered cash blocked in an bank account as collateral. Obviously, the loan was not needed to provide the capital for the purchase but to legalise the existence of the capital available for investment, as he was worried that the tax office might be surprised to found him having such a large amount of cash. This indicates that this firm did not report the total amount of sales turnover to the tax office (which might be a bootstrapping measure to be able to operate profitable), a strategy often used by Polish SMEs to reduce the tax burden, which is considered too high by the vast majority of entrepreneurs (Smallbone & Piasecki 1995, Ministry of Economy 1997).

4.4.3 Key points in section 4.4

- Bootstrapping measures are applied by small firms to overcome shortages in resources, which might be caused by the unavailability of external finance.
- They might be useful in the short term, however hinder the development of the firm in the long term.
- It appears that bootstrapping measures used by Polish SMEs include illegal measures, which might put the existence of the firm on risk.
- Polish policy makers intending to improve the financial situation for SMEs should eliminate regulations that lead small businesses towards bootstrapping measures.

5. THE BANKING SYSTEM IN POLAND, BANKING POLICY AND BEHAVIOUR

5.1 Introduction

Chapter five deals with the supply of finance, describing the characteristics of the banking system during the communist period as well as changes of the system under transition. The development of the bank lending structure is also described, with particular reference to lending to the private sector including problems banks faced with regard to lending after 1989. This is followed by policies of banks regarding lending to SMEs, which will be explained on the basis of the relationship typically existing between small firms and banks and the specific situation of Polish banks. The criteria that banks apply in their lending decision are also analysed. Finally, interest rate and collateral requirements by banks are described, since these have been cited by entrepreneurs as the main barriers in obtaining bank finance.

5.2 The banking system in the communist period

Despite the fact that according to socialist philosophy economies should function without the use of money and the existence of any financial systems, socialist economies in practice made use of both. However aiming at such principles meant that the role money and financial institutions played in the economy was certainly very different from that in developed market economies (Polanski 1995).

Under communism, the activities of commercial and central banking were not separated in Poland but combined in one institutional unit, the monopolistic National Bank of Poland (NBP). Furthermore there were three specialised banks, which were intended to be autonomous, although in practice they acted as agents of the NBP. These banks were:

1. **Bank Handlowa SA** - providing service to exporting enterprises.
2. **Bank Powszechna Kasa Oszczednosci SA** (Bank PKO SA) - handling foreign currency operations involving private persons, money transfers from abroad, sight and time accounts in foreign currencies.
3. **Bank Gospodarki Zywnosciowej** (BGZ) - catering for agricultural producers.
(Wyczanski 1993, Buch 1996)

The BGZ represented a special case as it included about 1,500 small and very small co-operative banks. The explanation for this was that the Polish agriculture proved impossible to collectivise with the result that it remained to consist of hundreds of thousands small family farms. This again made is impracticable to operate a centralised financial system. However these co-operative banks still depended on the central authorities, they were in fact "... as most other Polish 'co-operatives', state-owned enterprises" (Wyczanski 1993).

Following the pass of the Banking Law of 1982, two other specialised banks were founded in the 1980's,:

1. **Bank Rozwoju Eksportu SA** - Export Development Bank
2. **Bank Inicjatyw Gospodarcycg SA** - Economic Initiative Bank

The **Bank Powszechna Kasa Oszczednosci BP** (Bank PKO BP), a savings bank which handled the deposits of households and the financing of housing constructions was integrated in the structure of the NBP in the 1970s, however had been isolated again in the 1980s (Wyczanski 1993).

The National Bank of Poland was created by the Polish Provisional Government in 1945 and depended from the beginning on the Ministry of Finance, the Government and the Communist Party Leadership. The President of the NBP was nominated by the central government and with the introduction of a centrally planned economy developed on the Soviet model in 1948, the Bank became the administrator of the financial system on the basis of a central plan (Narodowy Bank Polski 1995). In reality this meant that the banks were not allowed to allocate credits to enterprises according to profit oriented decisions but that they had to follow central directives. The flow of capital was decided by the physical flow of means of production whose volume, pattern and direction again was determined by the plan (Buch 1993, Wyczanski 1993). Furthermore due to the specialisation of the banks the monetary circuits of the private households and the enterprises were separated. The deposits of the households held at the savings bank were transferred to the NBP which allocated credits according to plan to state-owned enterprises via their investment banks (Buch 1993, 1996). This system had different consequences regarding the function of money in the economy and the efficiency of the lending procedure.

Money in Poland under communism served more as a means of measuring than as legal tender, in other words money was used as a unit to express quantities within the plan rather than as a tool to distribute merchandise. Access to goods depended more on the target of the central plan and the actual availability of supplies. Having regulated prices meant that a shortage of goods was not indicated by rising prices, and fixed interest rates (often below the rate of inflation) made money not very attractive as a store of value. Furthermore due to the transfer of all assets from the savings bank to the NBP, book money could be swapped into cash only to the extent allowed by the central plan (Buch 1993, 1996).

As the banks had no say in the lending decision nor in the setting of interest rates, there was no reason for them to check the creditworthiness of a potential customer or the risk of a prospective investment. They were not in the position to reject funding applications or to force enterprises into liquidation. Furthermore, considering the monopoly structure of the economy which made the enterprises quite powerful and the fact that the companies as well as the banks were state-owned, the government usually guaranteed any loan risks to the banks (Buch 1993, 1996, Wyczanski 1993). As a consequence, efficiency of the use of funds was not often used as criteria in the lending decision (Wyczanski 1993). In conclusion, at the starting point of transformation, the banks not only had no experience in profit oriented approval of credit applications or

risk appraisals, but they were also inexperienced in dealing with small firms, as they, nearly exclusively, were used to serving large state-owned enterprises.

5.3 Structure of the banking system since 1989

Two important laws were passed in January 1989 in order to create a financial system suitable for a market economy. These laws aimed to transform the banks from passive agents of the central authorities into active financial intermediates:

1. The Banking Law
2. The Act of the National Bank of Poland (NBP)

The Banking Law contained rules for establishing commercial banks and hence created the basis for a universal banking system in which financial institutions were not only allowed to accept deposits and allocate credits but also to be active in investment banking (Polandski 1995, Buch 1996). The Act of the National Bank of Poland created a two-tier banking system by the separation of central and commercial banking. Nine universal commercial banks were created out of regionally based branches of the NBP, which started trading as independent organisations from the first of February 1989, taking over deposits and credits from the central bank. Consequently the NBP took on the role of a central bank, being responsible for the national currency, the financial system and monetary policy by using indirect economic tools, such as the amount and interest level of refinancing credit, the level of obligatory reserves, open market operations and discretionary methods such as the determining of the level of commission charged by the banks or limiting of banks' credit operations (Buch 1996, Polandski 1995, Narodowy Bank Polski 1995, Wyczanski 1993).

In the beginning of the banking reforms the NBP conducted very liberal bank licensing and required commercial banks to hold a relatively low level of obligatory reserves. Because of this the number of banks increased quickly, so that by the end of 1990, 75 banks operated in Poland, 30 of which operated with a majority share of private capital. By 1992 the number of banks had reached 120 (Wyczanski 1993, Buch 1993). In some cases banks were even established by enterprises in order to gain access to cheap refinancing credits (Buch 1996). In 1990, an act was passed allowing the co-operative banks to leave the BGZ structure. 104 co-operative banks took that opportunity to become independent, although the majority of banks decided to remain affiliated with the BGZ on a voluntary basis (Polanski 1995, Wyczanski 1993).

Despite the increase in the number of bank operation in Poland, the competition in the banking sector remained at a rather low level. One of the reasons was the size of the new banks, as the majority of newly established banks started banking with the minimum required capital. In fact, at the end of 1990 the combined balance of all private banks was smaller than that of the smallest state-owned bank (Konopielko 1997). Furthermore, they faced several problems, such as a lack of office space, a lack of experienced

banking staff, an inadequate infrastructure (especially with respect to the poor telecommunication network[12]) and a low capital base. Despite this, many offered the full range of retail and commercial services included in the universal bank business instead of concentrating on a niche which would have been more appropriate considering the small size and the lacking knowledge of these banks (Wenzeler 1997). By 1997, the banking supervision department of the NBP aimed at a reduction of the number of small private banks as the were regarded as non-sustainable in the long term because of solvency problems and the competitive environment (Wenzeler 1997).

On the other side, the former banks of the NBP had the advantage of a deposit insurance by the government, a developed network of branches and an established clientele. Especially PKO BP, the state owned saving bank, benefited from the loyalty of their customers, as they could not only use the banks branches to deposit and withdraw savings but also any Post Office in the country (Buch 1993,1996, Wyczanski 1993). The privatisation of the banks started in summer 1992 with the selling of Bank Rozwoju Eksportu SA, the Export Development Bank. 47,5 per cent of the shares were sold in public offering, 52,5 per cent were obtained by foreign trade firms and banks (Buch 1993). Two of the nine large regional state banks were privatised in 1993, although 30 per cent of shares remained in state ownership (Buch 1996). In 1995 privatisation continued with the selling of Bank Przemyslowo-Handlowy of Cracow and Bank Gdanski (OECD 1996b). As the Polish government was concerned with the small size of Polish banks (in comparison with foreign banks)[13], a major initiative was announced in 1995, involving the consolidation of the remaining state owned banks prior to their privatisation. The aim was to create a strong Polish banking system which could compete with large foreign banks once they enjoyed freer entry to the market (OECD 1996b). Therefore, the PeKaO S.A. Group was created in November 1996 by consolidating the state owned bank PeKaO S.A. with three regional state bank, Bank Depozytowo-Kredytowy S.A. in Lublin (BDK), Powszwchny Bank Gospodarczy S.A. in Lodz (PBG) and Pomorski Bank Kredytowy S.A. in Szczechin (PBKS). The group forms the largest bank in Poland, holding 21.8 per cent of assets and 24.8 per cent of deposits of the total banking system. (Bratkowski & Kawalec 1996, EIU 1997). Another consolidation emerged in 1997 between Bank Inicjatyw Gospodarczych (BIG) and Bank Gdanski, forming BIG Bank Gdanski S.A. (EIU 1997, National Bank of Poland 1998).

However state-owned banks or banks with a major state participation still hold the biggest share in the market. In 1996 overall state capital participation in the banking system amounted to 49.3%. Yet taking into account high concentration of assets in this group, the share of state-owned banks in the total volume of assets amount to 70.9% (Konopielko 1997). More specifically, with a share of about 70 per cent in both total credits granted and total deposits held in 1997, the state banks clearly dominate in the non-financial

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[12] In fact, the low level of telecommunication appears to have been the main reason for organising the former NPB banks on a regional level, thus adding to the problem of insufficient competition in the banking sector (Wyczanski 1993).

[13] The Polish banking sector is weak and dispersed by international standards. Banking sector capitalisation , the total sum of banks' own capital given as a percentage share of GDP, is nearly three times lower then the respective West European average. No Polish bank ranks among the worlds' largest 500 banks (PNB 1997).

banking sector, e.g. in trading with persons and businesses (Wenzeler 1997). This might indicate that in practice the majority of banks continue to be less concerned about their profitability, for example by lending to large uneconomical enterprises as they use to do under communism, expecting the government to take care of any losses the bank might cause.

Table 5.1: Top Polish banks according to the volume of assets (USD bln) and type of ownership at the end of 1996:

Bank	Volume of assets in bln USD	Type of ownership
PeKaO SA Group	13.63	State
PKO BP	12.79	State
BGZ	4.70	State + Co-operative
Bank Handlowy (BH)	4.55	State
Powszechny Bank Kredytowy (PBK)	3.44	State
BIG SA	3.25	Private + Public
Bank Slaski	3.11	Foreign + Public
Bank Przemyslowo-Handlowy (BPH)	2.66	State + Foreign + Public
Polski Bank Inwestycyjny (PBI)	1.58	State (NBP)
Bank Rozwoju Eksporty	1.29	Foreign + Public

Source: Polish Ministry of Finance in Konopielko 1997

Table 5.2: Ownership structure of banks (capital) in Poland at the end of 1996

	Per cent of total capital in the commercial banking sector
State Treasury	31.5 %
National Bank of Poland	9.5 %
State-owned enterprises	8.5 %
Polish private	9 %
Communal	0.3%
Other Polish (including co-operative)	13.7%
Foreign Majority	24.5%
Foreign Minority	3.1%

Source: National Bank of Poland in Konopielko 1997

Another problem is the low density of the branch network of the banks. In 1997 the Polish banking system provided 8,7 branches per 100.000 citizens compared with 64 branches per 100.000 citizens in Germany. This reflects the mentality of the Polish population to rely mainly on cash-based transactions instead of using facilities provided by banks. Indeed, while about 53 per cent of households maintain savings, only 20 per cent use banks (OECD 1996b, Konopielko 1997).

Foreign banks, which could have increased the competition in the banking market, showed only an limited interest in the Polish market in the beginning of the reform period. This was not only due to an uncertain

market environment and unfavourable conditions as mentioned above, but also because of regulations by the NBP after 1994 which made the equity investment in a domestic bank compulsory for the granting of a license to a foreign bank. Moreover between June 1993 and up to the end of 1994 not a single licence was issued for a foreign bank. In 1994 foreign banks contributed to only 3 per cent of total bank assets in Poland (Buch 1996, Wetzler 1997). According to an agreement with the European Union market entry barriers for EU-banks have to be lifted only from 1997 onwards and have to be totally removed by the year 2001 (Buch 1996). In other words foreign banks will then be allowed to open branches throughout Poland without the need to receive permission from the NBP. It is likely that foreign banks will account for increasing competition in the banking sector in Poland, since the foreign banks already operating in Poland are judged to be among the most successful in the country (with regard to their profitability), especially Citibank Poland (Wenzeler 1997).

5.4 Development of bank lending since 1989

Having been used only as agents of central planning under communism, banks lacked the ability to check the creditworthiness of loan applicants, to evaluate the level of risk involved in a potential project and to understand the use of collateral at the beginning of transformation (Polandski 1995, Wyczanski 1993). Because of this the banks extended overdue loans from state-owned enterprises and converted unpaid interest into principal (therefore reporting a high, if fictitious rate of return) instead of forcing the firm into insolvency. Another explanation is the fact that the local authorities had an interest in aiding the persisting of the large state-owned enterprises to minimise the growth in unemployment. Furthermore, there was also a lack of experience and experts in the liquidation of state-owned enterprises, at least during the initial stages of the transition period (Wyczanski 1993). This suggests that to change the institutional structure of the banking system was more easily done than to change the lending attitude of banks, in other words their behaviour.

This in combination with more and more enterprises experiencing payment problems after the freeing of prices, the reduction of subsidies and the collapse of the RGW market, resulted in an increasing number of bad loans (Buch 1996, Gomulka 1992). Even the newly developed private banks granted credits to unsound borrowers thus adding to the bad debt problem in the banking system. The reason for this is, similar as in the state banks, lack of information and knowledge. Moreover due to the regional monopolistic structure of the large state banks[14], the small private banks were forced towards the private business sector, which typically involved higher risk lending as it mainly consisted of newly developed small private enterprises.

In 1991 about 16 per cent of credits in the banking system were doubtful or lost and the share of bad debts in the largest state banks ranked from 18 to as much as 68 per cent of all loans (Wyczanski 1993). By the end of 1992 the share of non-performing loans amounted to about 27 per cent of all loans, and topped 32

[14)] The nine former NBP banks were based in different regions thus not competing against each other.

per cent in 1993 (Buch 1994, 1996). In February 1993 a law on the financial restructuring of enterprises and banks was passed by Parliament, intended to solve the problems of bad loans connected with credits before 1992. The scheme was based on the development and implementation of a restructuring programme and the creation departments specialising in dealing with bad debts, meant to improve the capability of bankers and to stress the importance of risk assessment and market techniques to bankers. Participating banks (seven of the group of nine which were formerly part of the NBP as well as PKO SA, PKO BP and BGZ) were endowed with ZLP 21 billion worth of government bonds in 1993. However, the recapitalisation of the saving banks and the agricultural bank was not combined with necessary changes in the control structure and business policy of these banks. Therefore a further 19 billion ZLP had to be spend on the financial restructuring of these banks in 1994. By 1995 the ratio of non-performing loans had lowered to 21.7% (Buch 1996, OECD 1996b).

The share of private sector credits in total domestic credit was rather low in 1989 at about 5 per cent, which is not surprising considering the dominance of large state-owned enterprises in the economy (Buch 1995). In 1990 the NBP urged the commercial banks to increase the share of new credits to private enterprises to 50 per cent which as a result grew to about 15 per cent by the end of the year, reflecting the rapid development of the private business sector during that period (Wyczanski 1993). At the end of 1991 credits to the private sector as a proportion of all credits to non-financial businesses (i.e. businesses not involved in any financial services), increased to about 23 per cent (Wyczanski 1993), although Buch (1994) reports a even higher share of 34 per cent. However she stresses that compared with the share of the private sector in production and employment (42 per cent and 51 per cent respectively in 1991) the share in credit underrated this sectors contribution to the Polish economy. Interestingly, while the share of credits to enterprises in general rose to 40.3 per cent of total assets of the commercial banks until the end of 1991, it decreased to just over 36 per cent by the end of the 1992. This indicated a trend towards credit rationing to non-financial businesses and a growth of credits to the Polish government, which coincided with the Ministry of Finance taking control over the nine former NBP banks at the end of 1991 (RWI 1994a, Buch 1995, 1996, Polanski 1995).

Lending to enterprises became increasingly risky since the majority of firms are said to have been making losses although low market value of accepted collateral and the slowness of court proceedings in collecting assets certainly contributed to this trend (Wyczanski 1993). Additionally, Treasury bills were issued in 1992 and sold below their face value, thus raising the effective yield above the coupon rate and therefore exceeding the refinancing rate set by the NBP. Hence commercial banks could make arbitrage profits (i.e. by taking advantage of different price levels) by borrowing from the central bank and investing these funds into treasury bills, without any risks involved (Buch 1995). Consequently the share of Treasury bills of total assets of commercial banks rose from 0.4 per cent in 1991 to 7.8 per cent in 1992. By the end of 1996 their share accounted for 8.4 per cent with securities in total amounting to 28.2 per cent of total assets (National Bank of Poland 1996 - Table 5.3).

Table 5.3: Structure of the Asset Portfolio of Commercial Banks in Poland 1994 - 1996

	1994	1995	1996	1997
Claims on non-financial sector (corporate)	31.6 %	31.6%	32.9%	33.4%
Securities	23.9%	27.0%	28.2%	24.8%
Claims on financial institutions	11.9%	13.7%	12.3%	12.7
Foreign assets	15.6%	11.0%	8.5%	9.7%
Claims on non-financial sector (persons)	2.7%	3.5%	5.6%	7.0%
Claims on general government	0.7%	0.98%	1.0%	2.0%
Other assets	13.6%	12.2%	11.5%	10.4%
Total assets	100%	100%	100%	100%
Total assets in million Zloty	120,952.9	160,064.3	207,638.9	263,320.9

Source: National Bank of Poland, Annual Report 1995, Information Bulletin 12/1996 and 1-3, 1998

By 1995, the share of credits to the private sector of total lending to the non-financial sector had risen to 51 per cent. Nevertheless, this still underrating the private sectors share in total employment (over 60 per cent) and contribution to the GDP (58 per cent) in 1995. Moreover, in the Polish statistics co-operatives are included in the private sector (National Bank of Poland 1995, U.S. Agency for International Development 1997). Information to what extent credit to small and medium sized enterprises has been increased with the overall growth in lending to the private sector by the banking sector is hardly available. None of the interviewed banks could divide their lending structure by the size of the companies. Statistics of the National Bank of Poland do differentiate between two groups of private entries, private companies, partnerships and co-operatives on the one hand and sole proprietorships on the other hand, however no information is given about the actual size of firms (Table 5.4).

Table 5.4: Structure of the Lending Portfolio to the non-financial sector of Commercial Banks in Poland 1995

Outstanding loans (by value) of which due from:	1995	Growth 1994-1995
Public sector	37.1%	123.9%
Private sector	50.8%	143.0%
private companies &partnerships, co-operatives	36.5%	145.7%
sole proprietorships	14.2%	137.7%
farming	3.5%	139.3%
other	10.7%	137.2%
Other organisations	0.1%	49.4%
Private persons	10.8%	122.7%
Total outstanding loans in bn Zloty	51.23	137.6%

Source: National Bank of Poland, Annual Report 1995

5.5 Banking policy and behaviour towards SMEs financing since 1989

5.5.1 Lending policy

When discussing the criteria banks use in their lending decision the relationship between banks and small firms and the problems following this relationship have to be understood. The banks provide finance to firms and in return expect the firms to generate an income for the bank. Thus, the firm has to be able to generate this income to repay the loan . It is therefore vital for the bank to be able to distinguish between sound and unsound propositions, which includes the assessment of whether or not the firm will be capable of successfully undertaking the project for which finance has been sought. While it can be assumed that most of the information regarding the above are available to the owner-manager of the firm, they are not necessarily at hand for the bank. Therefore the bank relies on data that the owner-manager supplies. This phenomena of information asymmetry leads to two types of errors the bank can make in their lending decision, which are the financing of a bad project and the non-financing of a good project. While the banks are less concerned about the latter error, as long as it does not seriously effect their profitability, the possibility of accumulating bad loans is a serious threat for banks (Stanworth & Gray 1991, Binks et al. 1992, 1996, Keasey & Watson 1993).

According to Storey (1994) banks have three different ways to cope with this lending risk: firstly they may seek to reduce the risk by making loans available only to firms which have a low probability of failure, secondly they may seek to ensure that, even in the event of failure, they obtain some return by calling in the collateral used to secure the loan, or thirdly they could increase the returns from the investment through the raising of interest rates. However the first solution of lending only to prospectively successful projects presuppose the ability to asses credit applications, hence to understand the small business sector. As this would require special training of bank staff, thus resulting in additional costs for the banks, it seams fair to ague that in an environment of low competition in the banking sector the banks would rather increase the interest rates in order to compensate the risk or rely on securities offered by the firms.

Nevertheless, to increase the interest rates might not necessarily be the right strategy, as this would probably discourage those firms that plan to undertake lower profit but therefore safer investments. Following this argument only firms undertaking projects with lower probability of success but higher rates of return when successful would require bank finance. This might increase the bank's share of bad loans, hence could lower their profits (Stiglitz & Weiss 1981). As an alternative, banks can require collateral to reduce the risk, which works in three ways. First, it is likely to result in a kind of self-selection of viable projects, as it can be assumed that only those who judge the probability of failure to be on a low level will apply, especially when the loan is secured by personal assets (Keasey & Watson 1993). Second, it ensures that the firm is truly committed towards the success of the project for which the loan is granted, the moral hazard problem (Binks & Ennew 1995, Hughes 1992). Third and most important, the collateral guarantees the recovering of the bank's investment even in the event of business failure or more precisely, its inability to repay the loan. However this method still does not prevent the banks from the risk of adverse selection, the possibility to

fund non viable projects if sufficient assets are provided as collateral and a complete analysis could not be done because of unacceptable high evaluation costs (Binks & Ennew 1995).

Furthermore, as profit margins in lending to larger firms are more attractive, and lending to larger firms usually proves to be less risky than lending to small firms, it is not surprising that banks, under the circumstances of low competition, tend not to show a particular interest in small businesses. This was the experience in the UK until the late 1960s (Stanworth & Gray 1991) and seems currently to be the case in Poland, as the banks do not differentiate between the needs of small and large firms and therefore do not have a lending policy designed for SMEs. In the UK, banks became more interested in the small business sector towards the end of the 1970s due to increasing competition and following decreasing profit margin in dealing with larger companies (Stanworth & Gray 1991). Nowadays all major banks in England have small business departments (hence banks staff specialised in dealing with SMEs), many of which have decentralised units (Fletcher 1996). As a good working relationship between the small business owner-manager and the bank-manager proved to be important to at least partly overcoming the information asymmetry[15], the majority of lending decisions to SMEs (over 90 per cent) are taken by local branch managers (Bank of England 1998).

With respect to the low level of competition and the non-differentiation between small and large firms by the banks, the current situation in Poland is similar to that in the UK until the late 1960s. However coming from a socialist background banks in Poland facing additional problem, arising from not being used to deciding upon the credit allocation, not being used to undertake any risk assessment and furthermore not being used to dealing with small firms. In an attempt to define the rules of lending in the Polish banking system (hence to introduce modern prudential principles), the NBP released recommendations regarding the bank's proceedings involving credit applications (Recommendation No.1) and regarding the review and classification of assets due from clients and from banks (Recommendation No.2) in August 1990 (Wyczanski 1993).

The NBP President's Recommendation No. 1 for Polish banks included the following requirements:

- to write down the lending principles of the bank
- to define the loan size to be allowed to be decided upon at the various management levels
- to specify the documents needed to be provided by the customers
- to adopt suitable rules of procedure
- to make an appraisal of the borrower's financial situation at least on an annual basis

(Source: Wyczanski 1993)

[15]) For further details see Cowling & Westhead 1996

The President's Recommendation No. 2 advised the rating of credits on the bases of the financial performance and the track record of debt servicing of the borrower. Therefore the following objective factors, subjective factors as well as some further assessment factors were suggested to be applied.

Objective factors:
- ratio of sales to the average level of assets
- ratio of sales to inventories
- analysis of liquidity coefficients
- composition of funds financing the operation

Subjective factors:
- quality of management
- dependence on the former Comecon
- dependence on government subsidies
- performance in debt repayment so far

Further assessment factor:
- The involvement in the production of goods and services that were overpriced or obsolete in comparison to goods coming from highly developed countries.

(Source: Wyczanski 1993)

Even though the recommended procedure of awarding credits did not differentiate to a great extent from those applied by banks in more mature market economies, the fundamental difference in Poland consisted of a lack of practical experience in handling such procedures. Moreover the system of competence in the banks was underdeveloped. Hence the mandates or limits depending on the position of the decision maker with regard to credit allocation was not clearly defined (Wyczanski 1993). Consequently the recommendations were unsystematic and too infrequently conducted which caused an increasing number of bad debts (See chapter 4.4). In the process of dealing with that problem banks were allowed to swap bad debts to equity shares, hence strengthened the already tight relation between banks and large firms (Buch 1993). The Lodz Region Economic Redevelopment Foundation for example noted that PBG banks on average own about 20 per cent of the biggest firms, e.g. 51 per cent of a large carpet company in Lodz.

However, evidence from the key informant interviews shows a slightly different picture. In Bank 3 for example, which is mainly state owned and has 54 branches in Poland, the loan manager deals with the firms, gives the application with his comments to the branch director for him to review. The final decision is then made by a credit committee in the branch, which consists of at least four people. In the case of very large amounts the decision is made by the credit committee at the headquarters. The procedure applied in Bank 2, which is one of the specialised state banks that were active during the communist period and which is still entirely state owned, varies slightly. After evaluation of the documents delivered by the firm a bank employee visits the firms site and reports to a loan manager who then proposes whether or not to give a loan and if so under what conditions. The proposal then is evaluated by a credit-committee in the branch who make comments on it and pass it on to the branch director for the final decision. Below 50.000 ZLP the loan

application goes directly from the loan manager to the branch director. It is the policy of the bank, that the decision is made by one person only, which is the branch director. In Bank 1, which has five branches and is mainly owned by a capital group from the Czech Republic, the credit decision is made either by the branch-director, the loan committee of the branch or the loan committee of the headquarters, depending on the size of the loan required. Once the final judgement is made the application is passed on to a loan manager whose task is to deal with the firm. This suggests that by now decision procedures applied by the banks have been improved, as the responsibilities and decision limits of the bank staff are more clearly defined. In most cases the loan decision is made within the branch, which is beneficial for dealing with SMEs as a working relationship can be build up. However this is neglected to some degree as the bank manager dealing with the firms does not necessarily have the competence to decide about the loan approval. Indeed, it appears that the final decision about whether or not a loan is granted, is made at least by the branch director, although in some banks only by the credit committee of the branch or the credit committee of the headquarters, depending on the size of the loan required. (By comparison, Lloyds Bank claims that 90 per cent of their lending decisions in the UK are "... taken on the spot."- Spence 1995) Therefore, the person deciding about the loan application does not necessarily know the owner-manager of the business, which suggest that for smaller as well as larger loan applications more formal lending criteria are applied.

5.5.2 Lending criteria

The criteria used in the lending decisions to small firms vary between the banks, although studies by Deakins and Hussain (1991) in England (ref. To in Fletcher 1995) and Fletcher (1995) in Scotland note that trading experience, existing profitability and equity stake are among the four most important criteria. The projected income is also of importance for English banks whereas Scottish banks put more emphasis on the gearing of the proposed project. However, the bank manager also stressed that the importance of the lending criteria might depend on the individual case. For start-up firms, for example, as they can't provide any track record of trading results, a high gearing of a proposed project would not be acceptable, whereas the same proposal made by a more mature company might obtain funding. In other words, in the case of start-ups, which are typically perceived as more risky than mature businesses, bank managers prefer the firm to provide more internal equity, since this adds to the value of the collateral for the debt finance sought.

Fletcher (1996) argues that the importance of trading experience in the lending decision of banks suggests that the people involved and their track record are critical. In other words, it is most important for the bank to be convinced that the owner-manager of the small firm has the ability to do what he says he will do. The emphasis on the personality of the owner-manager emerges from the fact that in small businesses the personal approach of the owner-manager directly influences the company's behaviour. Existing profitability is a further measurement with respect to the abilities of the owner-manager to undertake business, whereas the equity stake is of relevance regarding the gearing, indicating the degree of commitment by the owner-manager. The expected income on the other hand gives an idea of the maximum amount the firms could afford to borrow, hence the probability of the owner-manager's ability to service future loan instalments.

Furthermore, according to the Bank of England (1998), the banks have tried to improve the efficiency of their lending decisions by increasingly using credit scoring system in their risk assessment, which aims to reduce the costs for small business customers.

In Poland, evidence from the key informant interviews suggests that small businesses are not recognised as being different from larger enterprises as far as banks are concerned. Therefore banks can't divide their customers according to their size, nor do they apply different principles in the approval of credit applications by different sized firms. However, all four banks interviewed divide their customers by their type of book-keeping. Firms with simple book-keeping only have to keep a record of their sales, as they pay taxes as a percentage of turnover. Firms with a higher turnover have to apply a more complicated type of book-keeping, an accounting book, which the costs are also taken into consideration (Bank 3). Because of this, all four key informant banks indicated that loan applications are more complex for firms that have an accounting book than for those with simple book-keeping. However, only one of the managers (Bank 4) remarked that this would affect the process of the evaluation of loan application. (Unfortunately, it was not mentioned in what way the evaluation would be influenced.) Moreover, none of the banks interviewed indicated any differences in the lending criteria with regard to the size of the loan. However, two of the banks (Bank 2 and bank 3) mentioned that the requirements for personal loans are less strict than those for business loans. According to Bank 3, persons with a fixed monthly income receive a credit (up to 50,000 ZLP) almost automatically. The maximum size for personal loans in bank 2 are 10,000 ZLP.

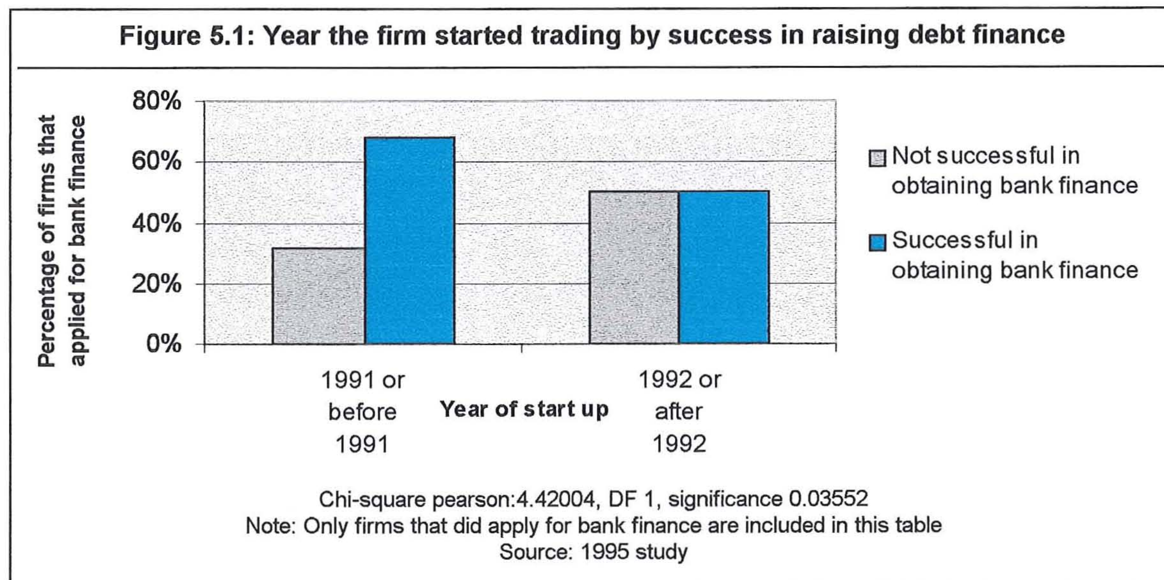
The actual criteria applied in the lending decision by the banks differ, although all responding banks mentioned the importance of financial ratios, such as cash flow and profitability, in order to evaluate the ability of the firm to generate income. Bank 2 uses the national ratio of the sector the firms is active in as a basis to evaluate the financial ratio given by the firm. Bank 4 employs a credit scoring consisting of nine chosen financial ratios. Another important parameter is the analysis of the market, in other words the capacity and the competition in the market. This is vital to ensure that the product or the service will have a future in the market. For example, a firm producing electrical equipment without any quality assurance certifications or standards (which will be compulsory in the future), would most likely have no future in the market and therefore not be granted a credit. In this context two of the banks investigate the age of the machinery and/or the equipment used by the firm and one bank also considers the way the firm is organised into account, e.g. the extent to which the firm has organised production, services and/or distribution according to market rules. (A procedure which is unlikely to be economical in the case of smaller loans.)

The existence of a positive history in dealing with banks, preferably a credit history, is also frequently noted by the Polish banks. In this regard Bank 1 and Bank 3 make use of the experience other banks might have had with a particular firm which is possible as the banks co-operate with each other in exchanging information about customers. According to Bank 3 banks have access to a 'Register of Unreliable Bank Clients '. However, it appears that not all banks have access to these information. Dickinson (1994) notes that the large commercial banks in Poland, whilst sharing data with each other, do not let small private

banks join their information network. The reason might be that the larger banks, which are either privatised or still state owned, are operating in different regions. As a consequence, they do not directly compete against each other, and regard the small private banks as their main competitors. Another criterion looked at by the banks is the existence of documents stating that the firm has no liabilities outstanding to the tax office and the national insurance institutes. One bank mentioned the age of the firms as one factor of their risk evaluation, probably referring to the fact that lending to more established firms is less risky than to younger companies.

Even though all the criteria cited by the banks are certainly of value in the approval of loan applications, they are clearly targeted at the approval of larger firms. The trading experiences and the characteristics of the owner-manager, which is of major importance in lending to smaller firms, are conspicuously missing in the criteria list of the Polish banks. Moreover, loan applications from small start-up businesses are unlikely to be assessed by banks at all, as they cannot meet any of the above criteria apart from the market analysis, which would be to costly to undertake for small loans. Only one bank interviewed indicated steps in a more appropriate direction for small firms by taking the qualifications of the owner-manager into consideration in their credit assessment. It is therefore not surprising that the analysis of our 1995 survey data did not show any statistically significant differences between successful and unsuccessful loan applications in terms of personal characteristics such as the level of the owner-manager's education, age, his/her background and previous experience of working in the industry. Moreover it appeared that loans were not approved in conjunction with financial ratios as credits were equally distributed between profitable and loss making firms and neither existing cash flow problems not falling profitability between 1992 and 1994 had any impact of the success rate of firms in obtaining bank finance. Unfortunately information about the year in which credits have been granted were not included in the survey. However, when looking at the year the firms started trading it appeared that firms that started trading before 1992 were significantly more likely to secure bank finance then firms that started trading in 1992 or later (Figure 5.1). Therefore it might be the case that majority of firms obtained bank finance in the early years of transformation when the assessment procedure applied by the bank in their lending decision were less developed and less criteria based. Moreover, there were more western funded credit lines available at this time compared with more recent years. This assumption is supported by a firm-level survey carried out by the World Bank in 1991, which shows that 65 per cent of the sample of 93 entrepreneurs had received short-term loans since 1988 (Webster 1991).

Figure 5.1: Year the firm started trading by success in raising debt finance

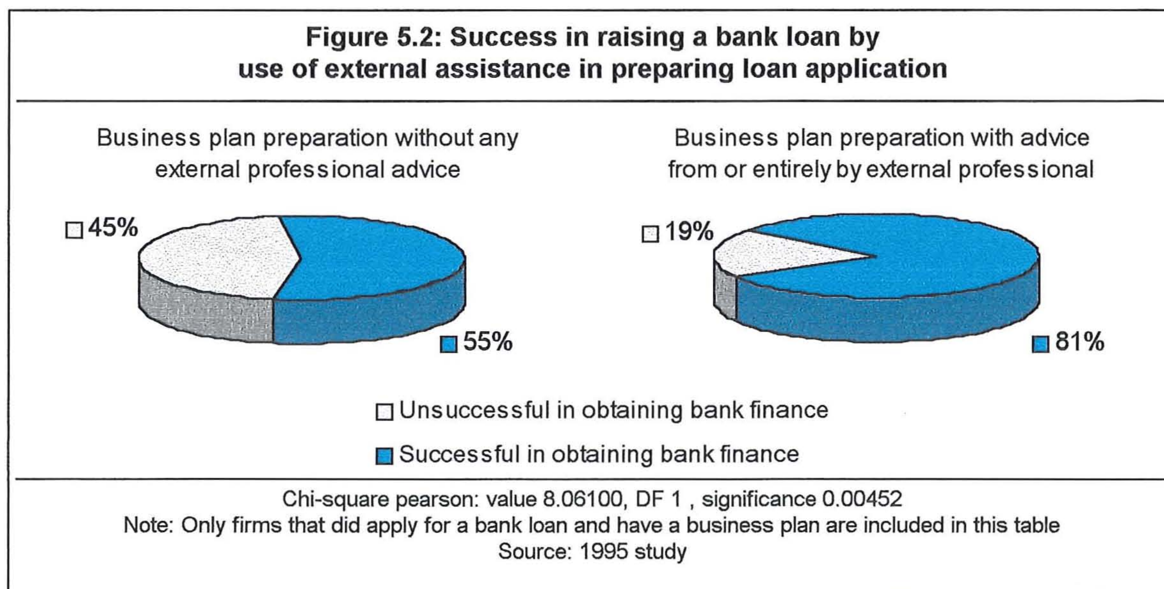


Chi-square pearson:4.42004, DF 1, significance 0.03552
Note: Only firms that did apply for bank finance are included in this table
Source: 1995 study

5.5.2.1 Role of the business plan

Analysis of the 1995 survey results indicates that the existence of a business plan has not necessarily been vital for a firm to receive bank finance, although it increased the chances of the applicant being successful. Indeed, 60 per cent of firms had been asked by their lender to prepare a business plan. Moreover, it can be seen that, when a business plan was required, it's professional preparation proved helpful in achieving success in raising bank finance. More than 80% of the firms which used external, professional help in this manner obtained credit compared to only 55% of firms which prepared their business plan without any such support (Figure 5.2).

Figure 5.2: Success in raising a bank loan by use of external assistance in preparing loan application



Chi-square pearson: value 8.06100, DF 1 , significance 0.00452
Note: Only firms that did apply for a bank loan and have a business plan are included in this table
Source: 1995 study

Evidence from the key informant bank interviews suggests that a business plan is only required in the case of firms applying for a term loan (Bank 1, Bank 3 and Bank 4), which Bank 2 defines as a loan with a period of between one and three years. Bank 3 and Bank 2 required a simpler business plan for smaller amount (less then 300,000 ZLP or less then 150,000 ZLP respectively), which does not have to be prepared by an external professional. However for larger credits the business plan is required to be prepared by a consulting firm or even a "well known" consulting firm. Bank 2 co-operate with a few consulting firms. Nonetheless, they do not suggest the entrepreneur to only use these firms. In the case of an overdraft loan or a short term loan Bank 4 requires information about the level of the current turnover as well as the expected turnover in the bank account of the firm.

Analysis of the 1995 study data concluded that Polish SMEs tend to require rather smaller amount of finance. Over half of firms (57 per cent) were interested in raising additional finance up to 107,000 ZLP, which is the equivalent to 150,000 ZLP in 1997 in consideration of an inflation of about 20 per cent in 1996 and about 17 per cent in 1997. The median amount of additional finance sought was 100,000 ZLP, or about 140,000 ZLP in 1997 prices. Moreover the majority of the 47 firms that raised bank finance to fund their investments in 1993-1994 (70 per cent) obtained up to 107,000 ZLP. Combined with the fact that credits to small firms are reported to be rather short-term (up to one year - RWI 1994a) one could expect that the existence of a business plan is not essential for the small firm to be successful in raising bank finance. However, this contradicts the above findings, that the existence of a professionally prepared business plan did indeed increase the chances of firms to access bank finance.

This might be explained by the time factor between the 1995 study and the key informant interview, in other words it might indicate that the banks developed their own assessment methods over time and therefore are now less concerned about the professional preparation of business plans. This suggestion is supported by the fact that the banks have started to improved the efficiency of their lending procedures by using credit scoring systems. Bank 2 for example employs a system that consists of two parts, the analysis of financial ratios and the subjective impression (i.e. the situation in the market, the qualifications of the owner-manager and the machines and equipment used by the firm). In order to qualify for a credit the applying firm has to reach a minimum amount of points in each part of the analysis. Bank 4 uses a similar scoring system, consisting of the assessment of the risk-profile and non-financial factors of the firm. The former include nine chosen financial ratios and the age of the firm, as younger firms are believed to be more risky, whereas the latter contains the economic activity of the firm and the proposed effects of the loan.

Moreover, one of the key informant interviewees from the Chamber of Commerce in Nowy Sacz (South Poland) confirmed that with more years in a market economy professionally prepared business plans of SMEs became less important for banks. Whereas a few years ago banks distinguished between whether or not the business plan was prepared by (or with the help of) a professional adviser, banks now (1997) emphasise more the quality of the plan, i.e. whether it is a realistic plan and not just one made to receive a bank loan. Further analysis of the 1995 study provides further proof. For those firms that started trading in

1992 or later, it made hardly any difference whether or not the business plan was prepared with the help or completely by professionals with regard to their success in accessing bank finance. However, this made a significant difference for those firms that started trading in 1991 or before (Figure 5.3 and 5.4).

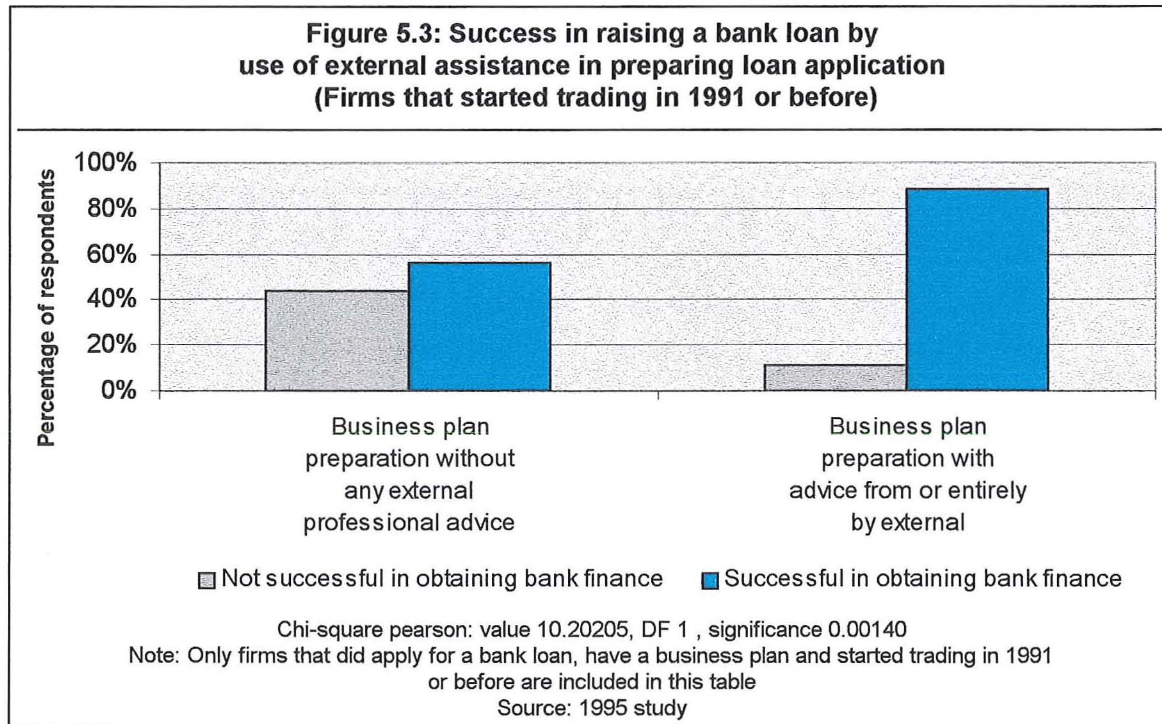


Figure 5.3: Success in raising a bank loan by use of external assistance in preparing loan application (Firms that started trading in 1991 or before)

Chi-square pearson: value 10.20205, DF 1 , significance 0.00140
Note: Only firms that did apply for a bank loan, have a business plan and started trading in 1991 or before are included in this table
Source: 1995 study

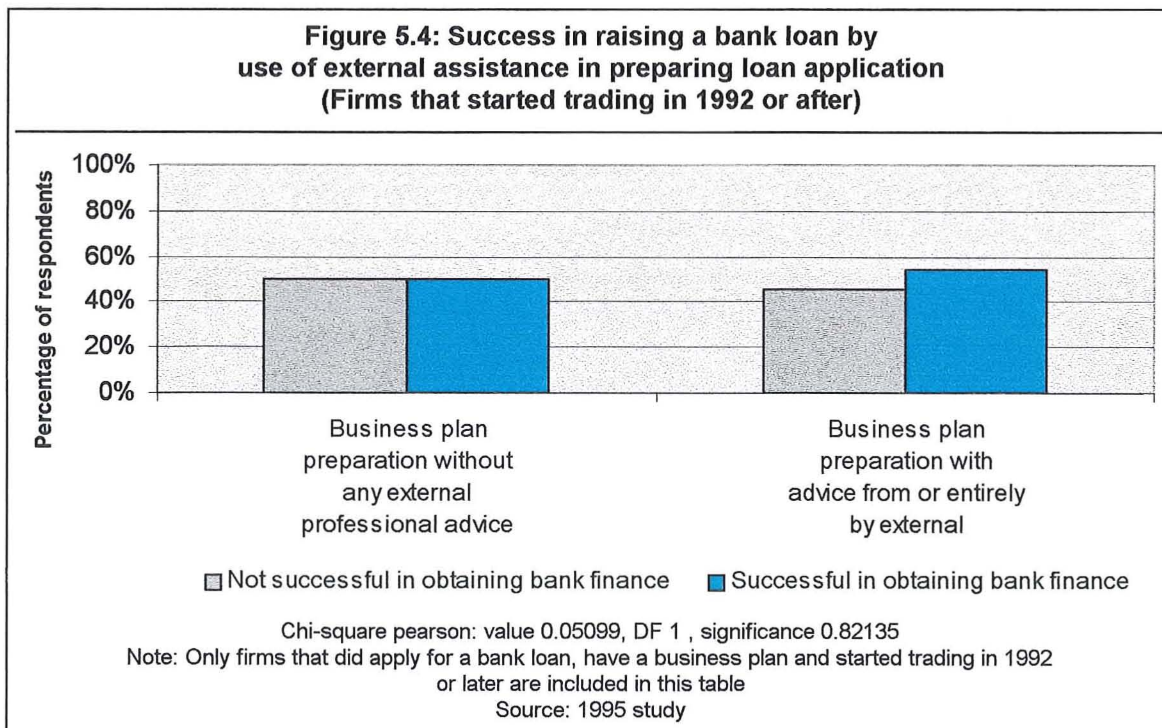


Figure 5.4: Success in raising a bank loan by use of external assistance in preparing loan application (Firms that started trading in 1992 or after)

Chi-square pearson: value 0.05099, DF 1 , significance 0.82135
Note: Only firms that did apply for a bank loan, have a business plan and started trading in 1992 or later are included in this table
Source: 1995 study

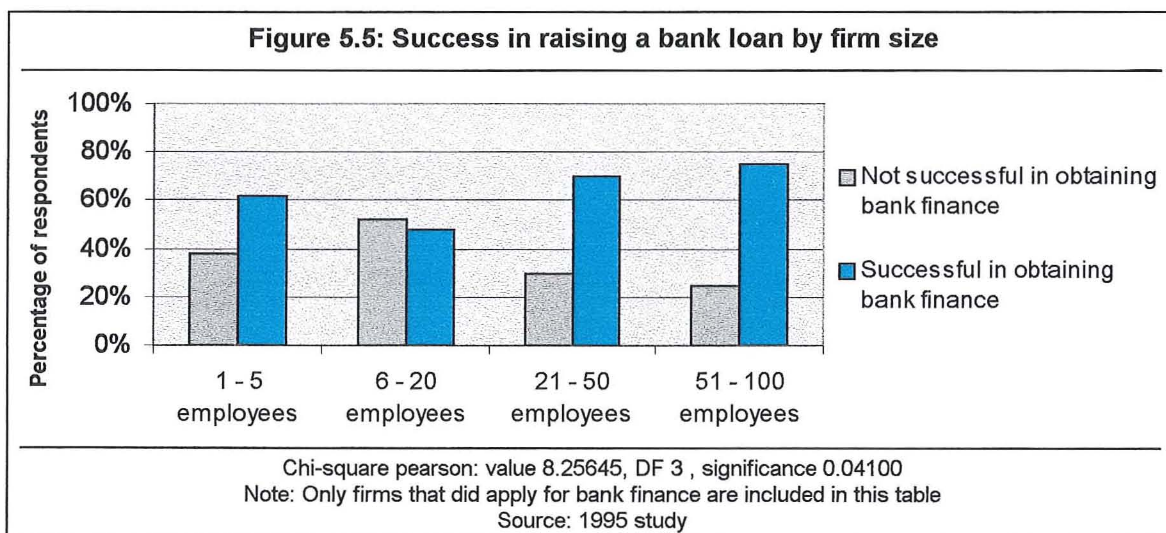
5.5.2.2 Situation of microbusinesses

Whereas banks might have improved their lending procedures as well as their credit assessment system, small firms were and still are discriminated against with regard to their accessibility to bank finance. Analysis of the 1995 study confirmed that the size of the firms (number of employees) significantly influenced the probability of obtaining loan from the bank (χ^2-test = 0.041 - Figure 5.5). Most successful were the larger firms in the sample employing between 51 and 100 persons as 75% of applicants obtained a bank loan , whereas firms which employed 6-20 employees were least successful (47.9%). Somewhat surprisingly, 62.1% of microfirms that applied for bank finance actually obtained it, hence stood a higher chance of success then firms with 6-20 employees.

However, it should also be highlighted that microbusinesses were least likely to apply for a loan in the first place (about 38 per cent of firms with up to 5 employees applied for a credit compared with about 64 per cent of the other firms in the sample) which suggests that there may be some self-selection among this group of firms (see section 4.2.2.2 for more details).

This suggestion has been supported by Bank 2 which reported that firms have used personal loans for their firms. As credits in general have to be secured by business or personal assets (see section 1.5.3) and as most of the business assets are financed with internal sources, the owner-manager personally guarantees for the loan in any case, regardless of whether it is a business or personal loan. It therefore makes sense for the owner-manager to apply for a personal loan if possible, as the requirements of personal loans are less strict. However, the downside are the costs involved in form of interest rates, which are likely to be higher for personal loans than for business loans.

Figure 5.5: Success in raising a bank loan by firm size



Chi-square pearson: value 8.25645, DF 3 , significance 0.04100
Note: Only firms that did apply for bank finance are included in this table
Source: 1995 study

5.5.2.3 External Factors

The reasons why smaller firms tend to be less successful in obtaining bank finance than larger firms, are certainly connected with problems in dealing with SMEs in general, such as the high level of risk involved in lending to small firms and the relative high rate of business failure. However in the case of Poland, factors associated with transition conditions are likely to make lending to SMEs even more problematic than those experienced in more mature market economies. An unstable economic environment with an inflation rate of 13,2 per cent in 1997 (National Bank of Poland 1998), which, even though much lower than in the early 1990s, is still high by western standards, makes businesses activities more difficult and firms less able to predict their ability to service loan repayments due in any future time.

Considering also the bad experiences that Polish banks had with loss making firms, the fact that banks can make attractive profits with treasury bonds and the low level of competition in the banking sector makes it understandable that Polish banks are rather risk adverse, demanding high levels of securities and interest rates. Nevertheless, as competition is likely to increase in the near future and with SMEs paying an increasing role in the economy, Polish banks should prepare themselves to enter the SME sector if they don't want to be left behind by foreign banks.

5.5.3 Interest rates

Part of the Balcerowicz Plan, the Government Economic Program which was introduced on 01.January 1990, was the liberalisation of prices and interest rates. As a result Poland experienced a hyperinflation of 112,536 per cent in January 1990, which varied between 24 and over 100 per cent in the following months (Buch 1993, 1994, Wyczanski 1993). Being unused to undertaking own projections of the monetary situation the commercial banks set their interest rates on the basis of the refinancing rate applied by the NBP, which they regarded as the official projection of the inflation (Wyczanski 1993). However as the future inflation rates were typically underestimated by the NBP (Table 5.5), real refinancing rates were negative in almost the entire period between 1990 to 1994, when based on consumer price changes (Buch 1995). The interest rates applied by commercial banks were close to the refinancing rate in cases of prime borrowers, hence negative in real terms in certain periods. Apparently, even rates charged to small firms were relatively low . A survey undertaken by Webster (1992) reports interest rates between 60 to 70 per cent for SMEs in May 1991, which, although high in absolute terms, are moderate considering an inflation rate of 60 per cent.

Table 5.5: Rate of inflation, December on December growth in consumer prices 1990-1996

	1990	1991	1992	1993	1994	1995	1996	1997
Rate of projected inflation	n.a.	n.a.	36.9 %	32.2 %	23.2 %	19.0 %	17.0 %	n.a.
Rate of actual inflation	250	60	44.3 %	35.3 %	29.7 %	27.8 %	18.5 %	13.2%

Source: Wyczanski (1993), Gronkiewicz (1998), National Bank of Poland (1998)
Note: n.a. = no data available

Nevertheless the maximum interest rate set by private banks often far exceeded the refinancing rate, leading to a range of more than 20 percentage points in interest rates charged by various banks (RWI 1994a). This again emphasises the low level of competition in the Polish banking sector. At the end of 1992 banks started to reflect more on the costs of obtaining funds on the inter-bank market, the Warsaw Interbank Offered Rate (WIBOR), as well as the profitability of Treasury bills in the calculation of their interest rates, which led them to start to apply a more profit-orientated, market economy behaviour (Wyczanski 1993, Buch 1996). In the following years the banks continuously lowered their interest rates to about 22 to 32 per cent for one year loans in March 1998, partly reflecting the stabilisation of the inflation (Table 5.6). The consumer price index in December 1997, measured as price raised since December 1996, accounted for 13,2 per cent (National Bank of Poland 1998).

Table 5.6: Zloty Lending Rated of Principal Commercial Banks for loans up to one year

1994	1995	1996	1997	1998
31% - 49.4%	24% - 44,2%	20.5 % - 28.8%	22.5% - 29.4%	22% - 32%

Source: National Bank of Poland (1995, 1996, 1998)
Note: (i) rates quoted by 15 commercial banks in December of each year
(ii) Till the end of 1997 figures present the lowest range of prime lending rates, which apply for lowest-risk loans, i.e. to borrowers in good financial standing
(iii) For 1998, figures present the range of minimum and maximum lending rates

Considering the high risks involved in lending to small and medium sized enterprises (Keasey & Watson 1993, Wyczanski 1993), it is likely that rates at the higher end of the range have been applied for small firms seeking bank finance. More detailed information from banks about interest rates for different company types are hardly available in the literature. However the key informant interviews give an insight into the lending policy to SMEs with respect to interest rates. In fact, as the banks do not differentiate between small and large firms, they always apply the same criteria in calculating the interest rate for a proposed project. The rates depend on the risk of the project, the repayment period, the overall profit the bank expects from dealing with the firm and the kind of collateral provided. For example if a firm that applies for a credit also brings other business to the bank, e.g. in the forms of deposits, fund transfers etc., then the bank might lower the interest rate in order to win the firm as a customer. Bank 3 would even go so far in lowering the interest rate to the point that they would not make any profit with the actual credit, provided the overall business expected from the firm is worth it. This strategy is well known in more mature market economies. In the UK, most banks offer some kind of start up service, i.e. special loans and free banking for a year, in the hope to increase their number of long-term customers (Stanworth & Gray 1991).

Although lending criteria appear to be equally applied to all firms, small firms in reality tend to be discriminated as they are usually seem as more risky and do not offer as much business opportunities as large firms. Hence they have to pay higher interest rates when compared with their larger counterparts. Bank 1 acknowledged this by mentioning that larger firms usually get better rates than smaller firms because of these reasons. However Bank 3 declare the size of the firm would not affect the interest rate they

demand yet stated that the interest rate depends on the overall profit the bank can gain from the co-operation with the firms. Consequently, smaller firms are indeed more likely to face higher interest rates than larger firm. Another factor that might influence the interest rate is whether or not the firm has an account with the bank and particularly whether or not only with that bank. If that is the case it makes it easier for the bank to evaluate the financial situation of the firm and this represents a "comfort factor" helping to reduce the bank's perceived risk. However, this would work both ways, as firms that are in a financially good position might receive a lower interest rate, whereas firms that are in a more problematic situation would be clearly identified as more risky and therefore might have to pay higher interest rates.

The same principle applies for firms that have a credit history with the bank. On the assumption that the firm proved to co-operate well with the bank they might get a lower interest rate the second or third time they apply for a credit. According to Bank 1 good co-operation means paying interest and repayment in time, acting according to any agreements set out in the contract (e.g. not to pay less than a fixed amount of money per month into the account) and a solid financial situation of the firm. It therefore seems fair to argue that new start up firms, as they do not have a business nor a credit history, are likely to face higher interest rates then more established companies. Bank 4 even includes the age of the firm in the evaluation or the risk-profile of business. Creditworthy firms are classified by their risk into four groups, A. B, C and D, with A being the lowest risk group. Firms that operate longer than three years might be ranked as A, although companies trading for two to three years will qualify for a B at most. Firms operating for one to two years will not be grouped better then C and those businesses trading for less then a year can only qualify for a D. Thus ceteris paribus new start ups will always be charged higher interest rates then more mature enterprises.

The banks were rather vague when asked about the level of interest rates that apply for credits to SMEs. The average level of interest demanded by Bank 1 is 28% pa., although the rate is higher for firms that apply for the first time. Furthermore, the customer base of the bank contains mainly medium sized firms with a turnover of 400.000 - 500.000 ZLP per month. Finally, as the bank does not divide its customer structure by firm size, the average rate might be distorted by lower rates given to larger firms. Bank 3 use the London Interbank Offered Rate[16] (LIBOR), and the Lombard rate as base rate, although they did not reveal any information about the margins they apply. At the time of the interview the Lombard rate accounted for 27 per cent. Bank 2 give a margin of 3.5% to 9% on the interest base rate, depending of the evaluation of the creditworthiness of the firm. This represents the basis of the interest rate calculation which then can be negotiated. Information about the interest base rate were not given during the interview. However, according to the Information Bulletin of the National Bank of Poland (1996, 1998), the base rate for prime rates of Bank 2 has been 19.5 per cent. The general base lending rate by commercial banks to businesses was 23.64 per cent on March 31, 1997 (EIU 1997).

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16) The LIBOR represents the base lending rate between banks in the London Eurocurrency market. It is used as an index for pricing a bank loan or line of credit (United Nations 1996).

The firm level case studies also provide a rather insufficient picture about lending rates for SMEs applied by Polish banks. Firms that had received loans in the early 1990s do not remember the rates they were charged (Case 2, 5, and 6) or received loans from foreign governments (Case 3 and 7). The first might indicate that firms were more concerned with the size of the repayment per time period due to serve the loan than the actual interest rate. In the case of firms 3, the US$ loan was granted in 1991 by western credit lines at a rate of LIBOR plus 6 per cent. Even though this rate was low in comparison with loans provided within Poland, the firms still experienced problems to serve the loan because of rising exchange rates. However, PBG SA bank took over the loan in 1992 applying the same rates and by 1997 had lowered them to LIBOR plus 4 per cent. At the time of the interview the owner was in negotiation with the bank for a even lower rate at LIBOR plus 2 per cent. Firms 7 received a loan from a western credit line, however can't remember the rates applied.

Nevertheless some firms that received loans more recently, reported rates applied by banks in lending to SMEs, which appeared to be in the range between 25 and 30 per cent. Case firm 2 applied for credit at the bank they used to deal with and would have got credit at a rate of about 30 per cent. The owner then decided not to take this offer, but to change to PKO which is charged a lower rate, which unfortunately he did not reveal. Case 4 secured a loan from Bank Handlowy in 1995, paying a margin of 6%. The base rate accounted for 24 per cent (National Bank of Poland 1995). In 1997, they enjoyed a overdraft facility on their account at a margin of 3 per cent. (The base rate at Bank Handlowy accounted for 25.39 per cent in March 1998 - National Bank of Poland 1998.) Case 5 received a two year loan for a car at a rate of about 25 per cent, which was arranged through the car dealer.

A so far unpublished research project, about credits granted to SMEs by the PBG Bank undertaken by the Department for Entrepreneurship and Industrial Policy in Lodz, Poland at the end of 1997 supports these figures. The researcher, who had access to the banks credit documents regarding four small firms, reports interest rates in the range between 26.5 and 28.6 per cent. The lowest rate referred to a 3 month loan granted to a firm dealing with scrap-iron that had several loans in the past and claimed to have a good working relation with the bank. The highest rate of 28,6 per cent was charged for a five year loan given to a business in the food industry, which is subsidised by the Polish Agency of Agriculture Restructuring and Modernisation. At the same time the firms had a one year loan form the bank, charged at 27.5 per cent.

By comparison, in the UK average bank lending margins to small business customers were about 3-4 per cent above base rate (6.25 - 7.25 per cent) during 1997 (Bank of England 1998, MoneyWorld UK Limited 1998).

The reasons for such high interest rates in Poland are not only the level of inflation, as real interest rates Polish small firms have to pay are significantly higher than those charged from their counterparts in the UK. In 1997, real interest rates in Poland were in the range between 12 to 17 per cent compared with about

6.25 to 8.25 per cent in the UK. Buch (1996) attributes the high Polish rates to the low level of competition and high costs, although the latter are caused by the low quality of the loan portfolio, inefficient methods of operating as well as necessary modernisation of the banking system. However, Bratkowski & Kawalec (1996) disagree with the first argument, but agree with the second. According to them the competition regarding interest rates is much stronger in Poland than in more mature market economies, as banks, while the whole financial system undergoes major changes, are fighting to maintain or increase their market share. As possibilities to compete on the basis of services (e.g. by offering new or better services) are limited in Poland, banks compete in prices. Nevertheless, Bratkowski & Kawalec (1996) stress that the main factor for high interest rates lies in the fact that Polish banks have to pay corporate income tax out of nominal profits, whereas other countries such as the UK enjoy tax allowances for the inflation rate (Finance Act 1998). Consequently, as shown in Table 5.7, Polish banks received a lower real interest rate after tax than banks in the UK, even though they originally required higher rates from their customer. Therefore, under the current circumstances, Polish banks can't lower their interest rates for their customers. In other words, if Polish banks are to improve the flow of finance to the small business sector by reducing the level of interest rates demanded, the government has to provide a working environment in which the banks stay profitable by granting corporate tax allowances to compensate for the inflation rate. The government should also aim at the reduction of the inflation rate in the first place, however this seems to be happening already as table 5.5 suggests.

Table 5.7: Calculation on the real interest rates after banks received from SMEs in Poland and the UK in 1997

Poland		UK	
Nominal gross interest rate	25% - 30%	Nominal gross interest rate	9.25% - 11.25%
- Corporate income tax	38% [1]	- Inflation rate	3.1% [2]
= Nominal interest rate after tax	15.5% - 18.6%	= Real gross interest rate	6.25% -8.25%
- Inflation rate	13.2%	- Corporate income tax	33% [3]
= Real interest rate after tax	**2.3% - 5.4%**	**= Real interest rate after tax**	**4.2% - 5.5%**

Note: 1) Piasecki at al. 1998
2) MoneyWorld UK Limited 1998
3) ISF1998

5.5.4 Collateral

Whereas interest rates decreased over the years since the start of the transition period, the criteria regarding the collateral demanded by banks seem to have become more strict. In the early years of transformation, banks appear to have been more liberal regarding the kind of collateral they are willing to accept, as for example declarations of surety from friends and family were widely accepted. On the other hand, real estate, because of often unclear ownership rights, has generally not been accepted as security (OECD 1996, Webster 1992, Slifirczyk 1992). In the following years, banks have become more cautious, preferring sellable assets like cars, machines, houses and cash blocked in an account as collateral, whereas guarantees were accepted only in certain circumstances.

In fact, the acceptance of securities other than assets as collateral was mentioned by only one key informant. This was Bank 2, which would accept guarantees from other persons for example to pay the credit in case the firm fails to do so. In one of the case studies (Case 4) a guarantee given by the main customer of the firms was accepted as collateral by Bank Handlowy in 1995. However it should be noted that this customer was an equity-shareholder of the firm, had an account at Bank Handlowy and furthermore is 60 per cent owned by Bank Handlowy. The fact that this firm could not get a loan in 1994 because of the lack of collateral, despite the above mentioned connection to Bank Handlowy is remarkable. Another firm (Case 7) was at the time of the interview under negotiation for a credit, for which they wanted to provide a contract with the customer as collateral. The firm considered the banks attitude as positive, although the fact that the customer was the PBK-bank certainly had a favourable influence on the banks decision.

The level of collateral demanded by banks has been reported to be high in the early years of transition, sometimes up to 300 per cent of the loan value (OECD 1996a). Moreover, evidence from the key informant interviews suggests that the percentage of collateral is still high, ranging from 100% up to even 500%. The actual value of securities demanded depends on the liquidity of the collateral, the financial prospects of the firm or the risk involved in the project and the existence of good previous co-operation with the customer. For example, one of the firms interviewed (Case 1) was asked to deliver assets to the value of 200 per cent as security, whereas another firm (Case 6) that provided cash blocked in an account as collateral, and hence more liquid security, was required to cover only 110 per cent of the loan value. In comparison, another firm (Case 2) cited that they had to provide machines worth only 50 per cent of the loan value as collateral for three loans obtained in the period from 1992-1993 whereas in 1997 bank demanded collateral to the extent of 100 per cent of the value of the loan. The usual level is about 130% to 150%.

However, the ratio to which the collateral is accepted ranges from as little as 30% up to 80%. In other words, only a certain percentage of the market value of the collateral is counted as loan security. For example if new machinery is provided as security about 80% of the market value is accepted as collateral, whereas in the case of old machinery only 30-50% of the market value will be accepted (Bank 3). Bank 2 assumed that the market value of fixed assets is the sum they are insured for 50% of which is accepted as collateral. Private houses are accepted with 50% of their value whereas floating assets such as cars are accepted with 70% of their market value. Consequently, the actual value of security firms typically have to provide as collateral is not in the range from 130 per cent to 150 per cent but in the range from 433% to 500%[17]. These findings are supported by the 1995 survey. The 63 firms that had sought bank finance but not received it cited insufficient collateral (45 per cent) as the most important reason whereas too high interest rates ranked only second (38 per cent). It therefore surprising that, according to Bank 3, most of firms think that the percentage of collateral demanded by the bank is acceptable. This might be explained by the fact that Bank 3 require more collateral then necessary in the first place only reducing the level

[17)] Under the assumption of only 30 per cent of the market value of the collateral being accepted as loan security.

demanded if the customer complains about it. This way the firm is convinced it is getting a good deal while the bank receive the percentage of collateral they want.

5.6 Key points in chapter 5

- Under communism, Polish banks were not allowed to allocate credits to enterprises according to profit orientated decisions but had to follow directives from the central authorities.
- At the starting point of transformation, Polish banks not only had no experiences in profit orientated approval of credit applications, but were also inexperienced in dealing with small firms.
- Despite an increasing number of banks operating in Poland in the new market environment, the competition in the banking sector remained at a rather low level.
- Market entry barriers for foreign banks will be removed at the latest by the year 2001.
- As profit margins in lending to larger firms are more attractive, and lending to larger firms usually proves to be less risky than lending to small firms, it is not surprising that banks, under the circumstances of low competition, tend not to show a particular interest in small businesses.
- In the UK, banks consider the trading experience of the owner-manager as critical in the lending decision to small businesses, which suggest that it is most important for the banks to be convinced that the owner-manager of the small firms has the ability to do what he says he will do.
- In Poland, banks do not consider small businesses as being different from larger enterprises, nor do they apply different criteria in the lending decision to different sized firms.
- The criteria mentioned by Polish banks in their lending decision (mainly financial ratios) are clearly targeted at the approval of larger firms. The capability of the SME owner-manager is not a key factor for Polish banks in lending to small firms.
- Small firms in Poland have to pay higher interest rates when compared with their larger counterparts.
- New start ups are likely to face higher interest rates than more established firms.
- Polish banks charge between 25 per cent and 30 per cent interest from SMEs. By comparison, banks in the UK demand between 9.25 per cent and 11.25 per cent.
- The fact that Polish banks have to pay corporate tax out of nominal profits might be one of the main reasons the high interest rates demanded by banks. Indeed, bank in the UK receive higher real interest rates after tax than Polish banks.
- Whereas interest rates decreased over the years since the start of the reform process, the criteria regarding the collateral demanded by banks seem to have become more strict.
- Polish banks typically ask for collateral between 130 per cent to 150 per cent of the loan value. However, considering that the ratio to which the collateral is accepted ranges between 30 per cent and 80 per cent, the actual value of security firms have to provide ranges between 433 per cent to 500 per cent. This acts as a real disincentive to SME borrowing.

6. INTERRELATIONS BETWEEN SMEs AND BANKS IN POLAND

6.1 Introduction

Chapter six looks at the experiences and problems small firms and banks have in dealing with each other, both from the viewpoint of firms and banks. This includes attempts to analyse the extent to which complaints made are justified. Finally, possible solutions aiming to overcome these problems are suggested, drawing on experiences made in more mature market economies.

6.2 Experience and complaints of SMEs in dealing with banks

In discussing the criticisms banks receive from small businesses in Poland, the experience of SMEs in more mature market economies such as the UK might be useful, since UK research has shown that the complaints that some SME owners make about the banks can be attributed to their own deficiencies. For example, Storey (1994) argues that the so-called finance gap with respect to small firms revolt from both demand and supply side failure. The external financing of small businesses has been the topic of various debates at least since the MacMillan Committee in 1931, which argued that small firms had difficulties in raising long-term capital of less than £200,000 (Storey 1994). Further investigations were made by the Radcliff Committee in 1959, the Bolton Committee in 1971 and the Wilson Committee in 1979. Whereas the Bolton Report concentrated mainly on the effects of tight credit for small firms, the Wilson Report, in response to the growing importance of the SME sector in the late 1970s, drew more attention to the quality of the credit provision, especially to the security levels required by banks. In conclusion the committee suggested that bank managers may be overly cautious in lending to small firms (Stanworth & Gray 1991, Binks & Ennew 1996).

However, not only because of growing criticism but also due to an increase in competition in the UK market as building societies and other institutions were allowed to enter the banking market, banks changed their approach to small firms in the 1980s (Binks & Ennew 1996, Stanworth & Gray 1991) According to a survey of 110 small firms based in Yorkshire 1985-1990 it can't be suggested that firms in general are being denied bank finance (Keasey & Watson 1995). Furthermore, some of the criticism banks received from small businesses or small firm sector representatives proved to be more a result of the type of financing, namely debt finance that small firm owners seem to prefer, rather than an attitude problem of the banks (Storey 1994, Keasey & Watson 1995).

The criticisms were mainly about "...the handling of small firm finances, overcharging in terms of interest payments and of not passing on interest rate reductions, of applying bank charges without informing the customer, being overly eager in calling in their loans and demanding too high a level of security." (Keasey & Watson 1993). These findings were more or less supported by Storey (1994), who co-ordinated a survey

of more then 10,000 small firms between 1989 and 1992. The main complaints made by small firm owners with respect to banks were about:

1. Bank charges (too high, customer don't get itemised charges, frequently calculated incorrectly)
2. Delay in passing base rate reductions on to customer
3. Collateral (Banks lend only against collateral and high level of collateral required by banks)
4. Unwillingness of banks to lend to high-risk/high-return borrower
5. Banks close down a business 'too early' if it gets into difficulties
6. 'Attitude' problems of banks, banks don't understand small firms.

Story (1994) concluded that criticism 1, 2 and 6 were not all justified. Most banks introduced itemised charges in 1992/93 and private computer programs to check charges are available. Changes of the base rate are centrally inputted into the banking computer system, hence banks are not able to choose which of their customers should receive the new rate. Moreover, bank staff training and reorganisation within the banks have led to improvement with regard to the relations between banks and the small business sector (Storey 1994).

Criticism 3, 4 and 5 are unavoidable to some extent, considering the fact that banks, due to the nature of the debt contract, do not share in any upside gains made by the firm. In other words, the beneficiary of an increased valuation of the firms is the owner-manager. The bank only benefits indirectly, as in the case of the firm doing well, interest and the principal are being repaid by the firm. However, as the banks do not receive more income if firms become more profitable, it is understandable, that banks do not accept any uncompensated down-side risk, hence are primarily concerned to protect their investment (Storey 1994, Keasey & Watson 1993). Moreover, some criticisms directed to banks are not always addressed correctly. Arguably much of the criticism banks received from small firms during 1991 and 1992 were in fact a result of an increase in business failure which was caused mainly by the government's high interest rate monetary policy (Keasey & Watson 1993).

Nevertheless, as argued by Binks & Ennew (1995), small firms can experience a loan gap as they typically have insufficient collateral to cover the loan. This is especially true for rapidly growing businesses, as their demand for capital may grow faster than the value of the purchased plant and equipment due to carcass-valuation procedures applied by banks. The Membership of the Forum of Private Business survey of 6,000 SMEs in 1992 confirms that fast-growing firms are significantly more constrained with respect to collateral, availability of credit, and term of loan. Interestingly the survey provides evidence suggesting that the collateral ratios are not the reason for the constraint but the type of collateral demanded by banks, which in the case of growing firms consisted more of personal collateral (such as the private house of the owner-manager - Binks & Ennew 1995).

A more recent survey by the Forum of Private Businesses (FPB) in 1994 ranked complaints about collateral demanded by banks fourth, after charges, interest rate and termination of overdraft (Binks & Ennew 1996 - Table 6.1), which suggest that collateral became less of an constraint for small businesses in the UK in accessing bank finance.

Table 6.1: Ranking of main constraints cited by SMEs in the UK in 1994

1.	Transaction charges
2.	Interest rate
3.	Threat of termination of overdraft
4.	Collateral
5.	Credit availability
6.	Competence of manager
7.	Speed of delivery

Source: Survey by the Forum of Private Businesses (FPB) in 1994 in Binks & Ennew 1996

By comparison, in Poland collateral seems to have become more of a constraint for SMEs since the start of the transformation in 1989, whereas transaction charges appear not to be an issue at all. In other words, it is the lack of availability of finance, not the cost of it, that is the problem. The main complaint cited in surveys in the early years of transformation was the high level of interest rates, whereas more recently the level of collateral demanded by banks seems to be the main criticism. A study by Grabowski & Kulawczuk (1991b) of 1,326 small private enterprises from the Gdansk Region in November 1990 - April 1991 reported that the main barriers in taking out bank credits were the extremely high interest rate (93 per cent), high collateral (36 per cent) and the reluctance of bank officers to deal with small firms (21 per cent). One year later Grabowski et al. (1992) conducted another study of 300 SMEs in Gdansk, Krakow and Lodz which although noting that interest rate levels were the most significant barrier to firms using external finance, this had been cited by fewer firms (84 per cent) than one year previously. 52 per cent considered the amount of collateral requested by banks as the most important barrier and 30 per cent mentioned the unwillingness of banks to service small firms. A study of 143 polish entrepreneurs by the RWI and the WSF Economic and Social Research Institute in June 1993 - May 1994 supplies a more detailed list of complaints made by small firm, with the level of interest still being the main problem (Table 6.2).

Table 6.2: Ranking of main constraints cited by SMEs in Poland in 1994

Complains	Percentage of respondents
1. Credit interest rates too high	78%
2. Bank credit guarantees too high (collateral)	65%
3. Banks unable to inform on government assistance	43%
4. Government assistance applied for, but not approved	38%
5. Application for assistance too complicated	23%
6. Credit allotments not fulfilled	22%
7. Credit application rejected	20%

Source: Welter 1994

In the 1995 study the order of complaints changed for the first time, as 48 per cent of the 63 firms that had sought bank finance but not received it, cited insufficient collateral as the most important reason and only 38 per cent the level of interest rates, reflecting declining interest rates as macro economic conditions improved (Smallbone et al. 1996). These findings are supported by the case studies of which most defined the collateral demanded by banks as the main problem.
However, in some cases external factors outside the banking sector are the reason for SMEs not being able to provide the level of collateral demanded by banks. For example Case 1, a manufacturer of leather chairs, could not provide the securities of 200 per cent demanded by the bank when applying for a loan even though he owned his private house. This is because for the last 30 years the government had been thinking of building a high-way directly through his house (a plan which has never been realised but that is mentioned in every relevant document) which is why the bank will not accept the house as collateral. Case 2, a kitchen manufacturer, would like to grow and to develop his business but can't access bank finance because of insufficient collateral. In order to provide his machines as collateral, he would have to insure them and that again would be too expensive.

Although other surveys report that Polish entrepreneurs often lack an understanding of why banks need security for loans (Welter 1994, OECD 1996a), the evidence given suggests that Polish banks indeed are too security oriented. Banks, as mentioned in section 5.5.2 , do not apply criteria designed for small firms in their lending decisions, hence are likely to compensate the risk involved in lending to SMEs by asking for high levels of security. This has been confirmed by one of the case study firms, case 7, who mentioned that banks look only for the collateral available. This is even more credible, as this firm managed to secure several loans and claimed to have a good relationship with their banks. The Lodz Region Economic Redevelopment Foundation also pointed out that firms with up to 20-30 employees find it most difficult to access bank finance, mainly because they do not have enough assets to secure a loan. Moreover, small firms in general, as mentioned in this context by the Lodz Incubator, are not in a strong position to deal with the banks. Indeed, Polish banks typically demand between 400 and 500 per cent of the loan value as collateral (section 5.5.4), whereas banks in the UK demand about 300 per cent for fixed-term loan (which is already higher then the level demanded by banks in the United States - Storey 1994). According to the Lodz Incubator, banks are also very strict with regard to the kind of collateral accepted, as they normally don't agree to personal guarantees. This makes access to finance more difficult for small firms, especially start-ups and businesses with insufficient assets. The inadequacy of the surety system, including sureties for SMEs, certainly contributes to the problem. The establishment of a surety and guarantee network, including those of a local character, "...must be considered too slow in relation to the needs" (Polish Ministry of Economy 1997).

Complaints about excessive interest rates are certainly understandable, considering the sharp rise of interest rates from 30 per cent in 1990 to more than 80 per cent in 1991, which came as a surprise for those who had received loans in 1990 but were inadequately informed about the method by which variable interest rates were set (Webster 1992). On the other hand, as mentioned in section 5.5.3, interest rates became even

negative in real terms in certain periods which might indicate that managers of small and medium sized enterprises tend to an overly strong orientation towards nominal interest rates, which can, at least in part, be the reason why they consider interest rate as too excessive (Webster 1992, OECD 1996a).

This suggestion is also confirmed by the 1995 study. The annual rise in industrial output prices (which applies in this analysis since all the surveyed firms were manufacturers) add up to 19 per cent at the end of 1995 (National Bank of Poland - Annual Report 1995). The majority of firms (77 per cent) surveyed in 1995 would have accepted interest rates (nominal interest rates) up to 23 per cent and on average even only 12 per cent (median). Therefore, the real interest rate (nominal interest rate minus the inflation rate) accepted by SMEs would not have exceed 4 per cent in most cases and would have been even negative on average. It could be argued that the annual rise in industrial output prices is an average figure and does not necessarily say much about the rise in sales prices individual firms could realise. Nevertheless the evidence given seems too strong to deny that the manager of the surveyed firms had unrealistic ideas with respect to interest rates. They do not seem to realise that banks are commercial enterprises which are in business to make profits and to give their shareholders a fair return on their capital. Moreover, the criticism of high interest rates might be addressed incorrectly to the banks. Because of the high inflation rate and the fact that Polish bank do not enjoy corporate tax allowances, bank have to apply a high level of interest rates in order to stay profitable (see section 5.5.3). For both the inflation rate and the tax system, however, the government is responsible, not the banks. Moreover, even so it might be difficult for SMEs to pay current interest rates, the answer to the problem is not as simple as given by the Lodz Incubator : "The banks should lower their rates".

The criticism of banks made by SMEs that they are not interested in dealing with small firms seems to be correct and appears to result from a low level of competition within the banking system as well as the existence of more profitable opportunities in the form of government bonds as outlined in chapter 4.5.1. Consequently banks do not have special strategies for dealing with SMEs and, even worse, bank staff dealing with lending decisions for small firms are reported to be poorly prepared and therefore orientated mainly on the collateral provided (Case 7). This statement is supported by the Lodz Incubator and the Lodz Region Economic Redevelopment Foundation. The latter also pointed out the old way of thinking of the banks which is still present from the communism period where banks were not used to lending to SMEs. Start up firms for example find it extremely difficult to open an account at Bank Handlowy. In every market economy banks would be expected to be interested in increasing the number of accounts. However, when they spoke to the chief of Bank Handlowy it turned out that the bank is more interested in mature firms who have a name in the market and who have more experience that get an account with the bank. It is more or less considered an honour for the firm to have an account at Bank Handlowy.

Welter (1994) also hints at the old connections between the manager of the large commercial banks and (former) state owned companies, i.e. normally larger firms, which might result in a certain reluctance of banks to follow legal bankruptcy procedures. One of the key informant interviewees addressed this problem

as a potential danger for the quality of the banks lending portfolio. In the case of this bank all employees in the credit department were replaced in 1993 by new staff due to informal ties to clients which probably has been the reason for part of the banks losses (Bank 4). Because of reasons like this as well an increase of competition which is likely to occur with more foreign banks entering the Polish market, one would expect the situation to improve for SMEs trying to access bank finance. Moreover, as cited by Bank 3, banks will increase their share of lending to SMEs due to the dynamics of their activity and will have to make their lending procedures more effective as they will have to enlarge their market.

The rather hostile environment for small firms in need of external finance that is currently present in Poland highlights the need for government assistance, either in the form of equity or credit guarantee funds. Considering the fact that most entrepreneurs are not aware of present support programmes (see chapter 3.3.1) the criticism of banks being unable to inform firms about government assistance is quite serious, as they, because of their networks, could play an important role in circulating such information. In fact only one bank, Bank 2, mentioned the existence of a government scheme, the loan guarantee scheme operated by the BGK bank, for which small business owner can apply at their branch.
However the bank also noted a low demand for this scheme, as up to then only one firm had inquired about the fund but had not even tried to apply for it. This, on the other hand, could again indicate the lack of information among SME owners with respect to the existence of such schemes. Therefore, the aim should be to integrate the banks into a well developed business support system, not only because of the banks potential in the circulation of information, but also because of their position as gatekeeper to credits.

6.3 Experience and complaints of bank in dealing with SMEs

The banks' risk of lending to non viable businesses (adverse selection) exists in every market economy, although it is likely to be higher in the case of Poland, as not only cost factors prevent the banks from undertaking proper loan assessments but also a lack of evaluation experience amongst their staff. Moreover, as mentioned in chapter 4.5.1, business prediction in Poland tends to be more difficult than in more mature market economies due to the unstable economic environment as well as because entrepreneurs themselves had to get used to financial discipline, which was neither practised nor needed under communism (Welter 1994). It is therefore not surprising that the Polish banks accumulated a large share of bad debt, especially in the early years of transformation, when both banks as well as firms found themselves in an unfamiliar and unstable economic environment. Consequently, in order to improve their profitability, banks try to avoid high-risk projects. Moreover, they are hesitant about lending to SMEs in general and to those with insufficient collateral in particular (Slifirczyk 1992, Polanski 1995). Given the low level of competition within the banking sector and the existence of profitable but safe investments in government bonds, makes the indifference of the banks to the small business sector understandable.

The problems the banks were citing in relation to lending to SMEs are similar to those surveyed in more mature market economies, namely the lack of assets which might be used as collateral, the high rate of

failure in the SME sector as well relative high evaluation and monitoring costs. However, the first might also steam from Polish banks demanding too high level of collateral as security in the first place. High evaluation and monitoring costs arise from the fact that it takes more effort to monitor 100 small firms than 10 or 15 large firms which would bring the same profit. However in Poland the high level of cost are not only a result of the small scale businesses typical in dealing with SMEs, as information given by SMEs to banks are often limited which makes any risk assessment for bank difficult. Smaller firms in particular, normally employ a very simple type of book-keeping which contains only receipts of sales, as they pay taxes as a percentage of their turnover. In such a case, it is rather difficult for the bank to asses the financial situation of the firm as no information about costs are given.

It is therefore not surprising that the banks complained about the poor level of information in the financial statements of small firms, which are not suitable to give sufficient information to the bank about the real financial situation of the firm. To obtain more data about the firm is difficult, requires a lot of work, thus increasing the evaluation and monitoring costs even more. Evidence from the key informant interviews highlights this problem as 60 per cent of the customers of Bank 2 and 50 per cent of clients from Bank 4 were reported to use only a simple type of book-keeping. Moreover many market economy institutions assisting creditors in risk evaluation such as credit information agencies, do not exist in Poland, which contributed to the problems the banking sector still face in evaluating credit worthiness of firms (Polanski 1995). Therefore, the complaint of Polish banks regarding the low level of information from small businesses and the high costs of loan evaluations appear to be justified, which certainly adds to the reluctance of banks to deal with the SME sector. In addition, one has to bear in mind, as mentioned by the banks themselves, that SMEs are a new sector and that the bank employees are still learning to deal with them.

Another problem cited by the Polish banks is that small firms usually try to hide their profits in order to lower the amount of tax payable (which makes this problem an issue for the government). This statement is supported by the fact that so-called shadow activities are estimated to have accounted for between 10 and 30 per cent of the GNP in 1993 (RWIa 1994), which might have a negative impact on the lending decision as banks can only consider official financial documents in the loan evaluation. Moreover the banks commented on unrealistic business ideas by the entrepreneurs. A small retailing firm for example applied for a loan in order to stock more similar articles to those they were offering already, even though they were not very successful in selling them. One bank also noted that many start up firms were not sufficiently specific about the exact use of the loan they wanted to apply for nor about the cost connected with setting up a firm, e.g. the price of machines, the conditions of payment for the machines etc. However, the relevance of this problem is difficult to prove with the available data, and requires further research. Another bank mentioned a problem that is related to the legal definition of a business partnership in Poland. A business partnership of two persons ceases automatically if one of the partners leaves the company. In such a case the only chance for the bank to recover their investment is by using the collateral. Again, this points to a weakness in the regulatory framework for conduction business, therefore is an issue for the government.

6.4 Possible solutions with regard to problems in the SMEs-bank relationship

In assessing loan applications banks can follow two procedures, a capital-gearing or an income-gearing approach. Capital-gearing emphasises the value of the collateral provided by the firm which is compared with the size of the loan requested. Providing the bank is convinced that the collateral is sufficient to protect it from any losses in the case of business failure, the loan might be granted. The income-gearing approach concentrates more on the expectation whether or not the firm would be able to serve the loan, thus looking at the income the business is likely to generate, in other words, emphasising the future prospects of the company (Binks & Ennew 1995). The latter approach certainly should be more desirable for both banks and SMEs. For banks, the risk of adverse selection would be reduced whereas for the latter the access to bank finance would be easier, at least for those with viable projects, as the level of collateral demanded by the banks would be lower.

However an income-gearing approach requires detailed information about the current and future financial situation of the firm. This information is most likely to be available for the owner-manager although not necessarily for the bank (information asymmetry). Moreover, it appears that for reasons mentioned in section 6.3 it is quite difficult and costly for banks to access sufficient information to overcome the information asymmetry in the current situation in Poland. Binks et al. (1992) even argues that:"... restricted access to finance is not attributable directly to size, but is instead a result of the problems associated with the availability of information from which projects are evaluated. Although such information problems are not unique to the small firm sector, they are considerably more prevalent there because of the anticipated higher costs of information collection."

While information asymmetries can't be eliminated completely, they can be reduced and the relationship between the small firm and the bank is the key factor in this respect (Ennew & Binks 1996, Binks & Ennew 1995,1996, Williams 1996). Binks & Ennew (1996) stress the importance of the company contributing to the relationship by sharing information with the bank. Their analysis of regular surveys of the membership of the Forum of Private Business (FPB) in 1988, 1990, 1992 and 1994 of between 3,500 and 6,100 small firms produced evidence to suggest that companies which participating more in building up a relationship to their bank were generally more satisfied with the service they received and perceived their business to be less constrained then the less participate firms. Suggestions on how firms can contribute to a good working relationship are given by Williams (1996).

Businesses should:

- work at the relationship by providing the management and financial information the bank has requested on time.
- be very clear about the negotiated terms and conditions.
- remember that banks are in business to make a profit, just like every company. In other words, if banks provide a service they are entitled to charge for it.

- try and make the bank their ally. If the bank manager trusts the owner-manager, he will support the business
- be clear that banks have enormous powers and can make or break businesses
- above all, as far as possible avoid giving the bank any nasty shocks. Firms should tell the bank about any unexpected bad news, such as the sudden loss of a major contract or a bad debt as soon as you discover it. Banks claim they are often unable to help simply because they are asked too late

Source: Williams 1996

In the Polish context this means that, in order to be able to provide sufficient financial information, firms that have only used simple type of book-keeping hitherto, should start to keep records of all finances of the firms, even though this might not be required by law (for tax reasons). A positive history in dealing with the bank as well as a long term flow of information between the small business manager and the bank manager makes the behaviour of the firm more predictable for the bank, thus less risky. In such a situation bank finance might become cheaper for the firm, as bank managers tend to grant finance or more favourable condition to customers with which they have a close working relationship (Ennew & Binks 1996).

In Poland, SME managers could not develop a personal relationship with financiers such as bank managers before 1989, because of the way the economy was organised under communism. However, with an more experience in a market economy small business owners have the possibility of building up a track record as well as a personal relationship with financiers. Not only has the importance of a positive history of SMEs in dealing with banks been mentioned in the key informant interviews (see relevant sections in chapter 5), but it has also been reported in some of the case studies. For example case firm 3 experienced improving co-operation with one of the major banks in Poland in terms of extending the repayment period from 4 to 10 years and in lowering the interest rate from originally LIBOR plus 6 per cent to LIBOR plus 2 per cent. The bank also proved to be flexible concerning the repayment term of the 235.000 US$ loan. (Originally the loan had been granted by western credit lines and had then been taken over by the Polish bank, which is why the loan is in US$.) Initially the firms had to pay US$ 20.000 every three months, although now they only have to pay US$ 15.000 every half year. When the company experienced turnover problems in 1996 because of a very cold summer, the bank again proved to be co-operative in agreeing to charge only half of the interest rate during the summer months. The owner himself explains that because he is working together for six years with the same group of persons in the bank they trust him. Another business (Case 4) came to a similar conclusion that for the bank it would be most important to have a good opinion about the firm. However in this case the good opinion of the bank did not compensate for lack of collateral but certainly counted for the acceptance of a guarantee from another company as collateral.

Equally the banks, providing they want to penetrate and develop the SME market, need to recognise the special requirements of SMEs, hence need to train their staff in understanding the small business sector, in order to contribute to a good working relationship. One of the case studies (firm 7) for example reported about a bank complaining about high fluctuations in the monthly turnover of the firm, a phenomenon

absolutely normal in their sector. Banks also should inform their customers about the constraints under which they are operating , e.g. the influence of the inflation rate, so that the firms know what they can expect in terms of financing (Binks & Ennew 1996).

Nevertheless, more years of experience as a market economy does not guarantee the development of a close working relationship between bank managers and small business owners. In fact the failure to form such connections has been identified as one of the weaknesses of the banking system in the UK, which, in comparison with countries like Germany and Japan, typically applies a more capital-geared loan evaluation (Binks & Ennew 1995, 1996). In the case of Germany it is argued that because of the existence of more banks, many of which are small and locally based, bank managers are able to develop closer working relationships with business owners than their British counterparts (Binks & Ennew 1995). Even though banks in the UK claim to become more orientated on business plans and cash flow projections in their lending decision, small firms still cite lack of collateral as a major barrier to growth (Bank of England 1998). Considering the low density of the Polish banking system (see section 5.3), the lack of staff trained to deal with SMEs and above all the current disinterest in dealing with small firms, it seems fair to argue that the banks are unlikely to improve their capital-geared approach significantly in the near future. But where viable projects are denied finance because of the lack of collateral potential economic growth might be foregone, which does justify the intervention of the government in the financial market.

In the UK such intervention has been taking place in the form of the Loan Guarantee Scheme (LGS) launched in 1981 which aimed to support small firms with viable projects that are unable to secure conventional loans because of the lack of collateral or/and the lack of a track record (Stanworth & Gray 1991, CEEDR 1995). In this respect the Loan Guarantee Scheme, according to Mason & Harrison (1992), appeared to play a small but significant role in assisting small firms to raise finance. Moreover, a survey of 100 small firms that borrowed under the LGS, undertaken by CEEDR (1995), reports that most of the firms took up the scheme because of a lack of collateral and that their projects would not have gone ahead without the LGS. Furthermore, the report notes that majority of firms were growth orientated and in fact did grow, both in terms of turnover and employment. However, the overall take up of the scheme was rather low with only an average five loans per 1000 eligible businesses. Several factors were suggested to be responsible for this, among them a lack of viable business proposals in general and a lack of firms that have viable projects but insufficient own capital or external finance opportunities in particular. Most of the businesses in the study area were very small, employing less then five people, and therefore had very modest capital requirements. Only a very small proportion of firms were reported to be growth orientated and in the need of external finance. This might also be explained by the fact that most who become self-employed have been long-term unemployed, achieved only a low level of education and are more or less being pushed into self-employment.

Another problem appeared to be the low awareness of the scheme among the small businesses. Banks seem not to play a significant role in raising awareness, as the majority of firms that had borrowed under the

scheme had first heard about the LGS form other sources than their bank manager, e.g. from the financial and trade press as well as from support agencies. Nevertheless, bank managers in general influence the use of the scheme, as all LGS applications are mainly made through banks (or other lenders), who are responsible for assessing the creditworthiness of the applicant. In other words, the bank manager determines whether or not a LGS application is submitted, hence acting as a "gatekeeper" of the scheme. Thus, the banks as well as the bank managers attitude towards lending to SMEs is certainly of importance. For example, even if managers are interested in dealing with small loans, they may not consider it worthwhile to use the LGS. Moreover, in the case of small loans for established firms, banks might find it more sensible to lend unsecured than to bother with the scheme. This in combination with the above mentioned deficit of loan proposals were security is the only thing lacking, leaves a very small gap for the LGS to fill (CEEDR 1995, Piasecki et al. 1998).

Becoming more aware of the importance of SMEs in the process of transformation, the Polish government established a Loan Guarantee Fund in the Bank Gospodarstwa Krajowego (BGK - Bank of the National Economy) in December 1994. The programme, administered in co-operation with 12 large commercial banks, was designed particular for Polish entrepreneurs independently of their legal status employing up to 250 persons, an annual turnover below 20 million ECU (70.000.000 ZLP) and total assets of no more then 10 million ECU (35.000.000 ZLP) - the EC definition of a small or medium sized enterprise in 1994. The scheme can only be used in the case of credits for investment, credits for production, implementations of "know-how", purchase of property of privatised state enterprises, environmental protection , rise in export and in the creation of new jobs and enterprises. The programme guarantees up to 60 per cent of the loan (some sources report 70 per cent) and the collateral requirement of the guarantees proportion of the credit is 50 per cent. Maximum size of the loan is two million PLZ with a maturity of up to five years. The fee ranges from 1.2 to 2.0 per cent, calculated on the value of the loan (Hübner 1996, The Delegation of Poland 1996, Suzuki 1996, Notes from a information board in the Incubator in Lodz in 1997). As in the UK, loan guarantee applications are not accepted by the BGK directly from businesses, but are submitted by one of the banks they co-operate with, provided this bank considered the proposal creditworthy (The Delegation of Poland 1996).

Considering the strong demand for external finance among Polish entrepreneurs, their growth orientation, their solid educational background, their reported difficulties in obtaining bank finance due to insufficient collateral as well as the fact that banks do not tend to lend unsecured, one would expect to find a strong demand for the loan guarantee scheme. However the BGK bank had received only 17 loan applications by September 1997 (Chamber of Commerce, Nowy Sacz). One of the banks (Bank 2) at which the loan guarantee scheme is available mentioned that they had only one firm enquiring about the programme but that in the end it did not apply for the scheme. One reason for the low take up of the loan guarantee scheme might be the low awareness of it among the small businesses, due to lack of available information as mentioned in chapter 3.3.1. This seems not to be unique in Poland as the UK study also identified a need for more publicity. Moreover, a significant minority of UK borrowers under the LGS criticised the way in

which the access to the scheme is controlled, as they had to contact a number of banks before finding one that would help them (CEEDR 1995). Considering the face that the large commercial banks in Poland are much less interested in dealing with SMEs then their counterparts in the UK, they are (as in the UK) in a position to decide whether or not a proposal is submitted to the BGK. In other words, they are the "gatekeeper" of the scheme, which means it is not surprising that the level of take up of the scheme is rather low. This suggests that in order to increase the number of take ups the influence of the banks in the application of the scheme should be decreased. In Germany, for example, several private credit guarantee association operate in each region, formed by financial institutions, local authorities and trade associations. The associations are financially supported by the regional (Land) governments as well as the Federal government. Other sources of income include guarantee premiums paid by borrowers and profits from investments. The funds are used to provide guarantees for bank loan, however the creditworthiness of borrowers is not only assessed by the banks but also by the chambers and trade organisations. Similar bodies exist to guarantee equity investments in SMEs (Kayser & Ibielski 1986, Bannock & Albach 1991, Piasecki et al. 1998). In some regions, such as Hessen, a Land development agency deals with applications for loan guarantee schemes on behalf of the Land government as well as granting own credits and loan guarantees (Bennet & Krebs 1991).

The Lodz Region Economic Redevelopment Foundation already started to think in that direction by preparing a local loan guarantee fund which will be provided by the local labour office and their foundation in association with banks. The programme aims at start ups and SMEs which are aiming to grow. It has already been accepted by the local labour office and the local government administration and the Foundation is now awaiting approve from the central labour office. According to the Foundation, finance for start ups is possible to find, but difficult to access. The labour office for example offers loans for start ups, however they are small (30.0000 - 40.000 ZLP) and therefore more suitable for start ups in the service or trade sector. The interest rate is quite attractive, about 75% of the average interest rate normally charged by banks. In theory the loan is easily accessible because the level of collateral demanded is not as high as that demanded by banks, but there is a queue of firms waiting to be funded. Moreover only those officially registered as unemployed are eligible for the loan which is a serious constraint for all working persons and which is why the Lodz Region Economic Redevelopment Foundation wants to set up the local loan guarantee scheme.

Other loan guarantee funds set up with foreign or international aid are the *Polish-British Enterprise Project* (PBEP), the *PHARE Local Initiative Programme* and the *Programme for Structural Development in Selected Regions in Poland* (STRUDER). The *PHARE Local Initiative Programme* has been founded in 1993 in eight communities as part of the European PHARE Local Initiative Programme and is administered by the Co-operation Fund under the direction of the Ministry of Labour and Social Policy. The programme provides a whole support package of loan guarantees, loans, equity investments, education and training as well as assistance for the development of business support and incubation centres (Suzuki 1996). Nonetheless, due to the regional restrictions and problems with the managing bank, the flow of resources is

reported to be rather unsatisfactory (RWI 1994b). The PBEP started in autumn 1994 to provide an integrated support programme for SMEs, however it is operating in only two voivodships, Lublin and Bialystock (Hübner 1996, Suzuki 1996). Instead of running several different loan guarantee schemes it might be more effective to co-ordinate different sources into larger funds which could be more easily promoted and which might be even more attractive for banks to get involved with. One the other hand, larger funds might increase bureaucracy and therefore influence the flexibility of support schemes in a negative way. A united guarantee fund which would co-operate with a number of banks is suggested by the Lodz Region Economic Redevelopment Foundation to be very useful. Their future model would include bank as well as non-bank funds and would, at least at present, need money from the government, the council and non-government institutions. Therefore a good regional policy and development funds are needed, but also other services such as information and advice, as the financial package should be only part of a bigger programme of support.

In this context, the Foundation also pointed out that changes in the administrative structure would be necessary, e.g. the introduction of larger voivodships and of institutions which are operating on a regional rather then on a national level. Moreover in the current system only a small part of the government revenue (15-20%) goes directly to the region, the rest goes to the central budget and is then redistributed to the regions. In the opinion of the Foundation most of the funds, about 70 per cent, should be kept in the region as the local government can locate the need more easily than the central government. Furthermore the Foundation remarked that local government recently started to change their way of thinking. They began to understand that with a rising number of firms the level of taxes revenues rise, the support necessary for the unemployed decrease, hence the social costs in general decline. Therefore they start to realise that if they support local businesses they are supporting the regional development and the people in the region.

6.5 Key points in chapter 6

The main findings of section two and three of this chapter are listed in table 6.3 and 6.4.

Table 6.3: Main complaints of Polish SMEs in dealing with banks:

Criticism:	Comment:
Banks are too security orientated.	Appears to be justified.
Interest rates are too high.	Criticism appears to be addressed wrongly to the banks, as current inflation rate and corporate taxation system leave little room for reducing interest rates.
Banks are not interested in dealing with SMEs.	Appears to be correct.

Table 6.4: Main complains of Polish banks dealing with SMEs:

Criticism:	Comment:
Lack of assets to be used as collateral	Might also stem from Polish banks being to collateral orientated in the first place.
Low level of information given by small firms.	Appears to be justified.
Small firms usually try to hide their profits.	Appears to be justified.
Entrepreneurs have unrealistic business ideas.	Difficult to assess with the data available.

- Costs and problems in accessing information about small firms appear to be one of the main reasons for Polish banks to apply a more capital-geared approach in their assessment of loan applications of SMEs.
- Owner managers of small firms can contribute to overcoming these problems by sharing information with the bank.
- In order to be able to provide sufficient information, small business owners should keep more sophisticated financial records.
- Banks, providing they want to penetrate and develop the SME sector, need to train their staff in understanding the small business sector.
- Considering the current disinterest of Polish banks in dealing with SMEs, government intervention in the financial market appears to be necessary.
- The Polish government established a Loan Guarantee Scheme in 1994 which is administered by 12 large commercial banks, but which has had a low take-up.
- Government intervention in the form of credit guarantees is useful, however the banks, even if they should be involved in such schemes, should not act as "gatekeeper " of the scheme as this appears to influence the number of take ups in a negative way.
- Other loan guarantee schemes operating on regional level are set up with foreign or international aid.
- Instead of running several different loan guarantee schemes it might be more effective to create larger funds which could be administered via small business support or/and regional development agencies. Such funds might even be more interesting for banks to co-operate with. However, care should be taken that funds are not becoming too inflexible and bureaucratic.

7. CONCLUSIONS AND IMPLICATIONS FOR POLICY

7.1 Introduction

In chapter seven the main finding of the thesis will be summarised with respect to the aims as specified under section 1.1, followed by recommendations to entrepreneurs, bank manager and policy-maker about the type of strategies that could be used to increase the rate of bank finance to SMEs.

7.2 Factors influencing the decisions made by Polish SME owners with regard to their sources of finance

The factors influencing the decisions made by Polish SME owners with regard to their sources of finance are of both internal and external nature.

Internal factors include:

1. the personal preferences of the owner manager
2. the characteristics of the business

External factors consist of:

1. the situation in the market
2. the availability of external finance
3. the terms to which external finance is available
4. level of information about available external sources of finance

Polish firms appear to be more growth orientated than their counterparts in more mature market economies. The 1995 survey showed that 88 per cent of firms had been growth orientated in 1993-94, with 66 per cent considering growth as an important object. This might be explained by the fact that setting up a business has not only been seen as a possibility to seek independence and self-fulfilment, but also to increase income and the standard of living, especially against the background of declining large state companies in the newly emerging market economy and the limited possibilities of wealth accumulation in the past. This indicates that, even though currently growth orientated, the motivation of part of the Polish owner-manager might change as soon as their business generates income sufficient to realise an acceptable live style.

The fact that small business ownership was restricted during communism, means that most exiting small firms in Poland have been set up after the political changes in 1989, hence are rather young when compared with western market economies. It is therefore not surprising, that statistics of the size structure of the private sector in Poland show a general deficit of medium sized firms employing between 51 and 249 persons when compared with the private sector in the UK and Germany. Moreover, Polish small businesses are generally smaller in terms of the average number of employees than their counterparts in more mature

market economies. This supports the argument that growth ambitions of Polish small firms might decrease over time, as at a certain firm size internal funds might not be sufficient for further business expansion. Therefore, the owner-managers wish to stay independent has to be offset against his/her interest for further increases of the personal income by accepting external finance. This might also explains why, as soon as external finance becomes necessary, debt finance provided by banks proved to be the main source of external finance for SMEs, as debt finance does not challenge the control the owner of the firm has over the business. This phenomenon is also typical for SMEs in more mature market economies.

The 1995 study shows a high interest of Polish firms (80 per cent) in external finance, which might not only be explained by their strong growth orientation, but also by the fact that the majority of surveyed firms (87 per cent) were constrained in their development by a lack of finance. Moreover, some firms are also pushed towards external finance, as they need to invest in order to keep up with rising competition in Poland. The median amount sought was 100,000 ZLP, the lowest about required was 5,000 ZLP and the highest amount was 11,000,000 ZLP. In 1995, no evidence could be found that a demand for long term debt finance exist among Polish SMEs. However, this might have changed with more years in a market economy, as evidence from the case study firms suggest that Polish businesses show an increasing interest in larger and longer term investments, for which they have difficulties to provide sufficient collateral and which banks are reluctant to grant.

The amount of finance sought also depends on the particular characteristics of the business:

- Firms in the food processing sector typically required twice as much finance as firms in the other sector, probably because of the expensive machinery needed in this sector (Smallbone et al. 1996).
- Older companies (firms that had started trading before 1989) showed a slightly higher demand for additional finance then younger firms. This might indicate that their internal resources had already been used for adjustments necessary to adapt to the new market economy.
- Microenterprises needed the highest amounts per employee when compared with other size groups, probably due to their low level of internal sources and their backlog demand for investments. This might indicate that microenterprises need funds partly to raise their technical standard to that of their competitors, and hence to survive, whereas the larger firms in the study required further finance mainly for product development and growth. However, the larger sized firms were more likely to apply for debt finance than smaller businesses. Nevertheless, those microenterprises that did apply were more successful in obtaining debt finance than slightly larger firms. The reason might be that the private assets of smaller firms present sufficient collateral for the size of loan needed, whereas such security might not be enough to cover the amount sought by slightly larger firms.

Even though Polish SMEs are highly interested in raising external finance, they rely to a greater extent on internal sources, both for start up and investments, than their counterparts in the UK. This might be explained by the fact that banks (even though they are the most usual providers of external finance to SMEs

in Poland, as indeed they are in the UK) proved to be rather reluctant to deal with small firms. Therefore Polish banks do not apply lending criteria design for SMEs, hence demand high level of collateral of up to 500 per cent of the loan value. Another possible source of external finance for Polish SMEs are public support programs and venture capital funds. However, most support programs proved to be unsuitable for SMEs and the availability of formal venture capital funds is limited in Poland; those that exist are mainly interested in larger firms. Moreover, the flow of information about these sources of finance appears to be rather poor. Informal venture capital (provided by so called Business Angels) which have been become significant as an equity source for SMEs in the USA as well as in the UK could also be of interest for Polish SMEs. Indeed, not only do Polish SMEs show a high interest in venture capital, but could even be of interest to potential business angels in terms of their growth ambitions, growth potential and their level of education in their field. Surveys regarding the existence of business angels in Poland are not available, although it is not very likely that many of them exists in Poland. They are described in the western literature as typically to be high net worth individuals who have personal entrepreneurship experience, normally with background in industry and commerce (Harrison & Mason 1995). Bearing in mind the short period of time that entrepreneurship has been accepted in Poland, one would expect potential Polish business angels still to be in the phase of developing their own business. A solution might be to create business angel networks which could be operated by Polish small business support agencies, aiming to find foreign as well as Polish investors one via modern communication systems such as the Internet. This might be especially interesting for Polish emigrants who are now returning to Poland, some of whom have become wealthy entrepreneurs (Scase 1997). However, further research in this area would be needed, especially as the high interest of small firms in venture capital is likely to stem from the fact that Polish SMEs experience difficulties in accessing debt finance.

Once internal sources are depleted, external finance becomes necessary. However, some firms in Poland do survive without external finance by applying "bootstrapping" measures such as tight cost management or the employment of members of the family who work without expecting regular wages. However, even though they might be useful in the short term, this certainly hinders the development of the firm in the long term. Moreover, it appears that Polish SMEs are also using illegal measures, which might put the existence of the firm on risk.

7.3 Factors influencing the policies of Polish banks and bank behaviour with respect to small firms in Poland.

The factors influencing the policies of Polish banks and bank behaviour with respect to SMEs derive from the historical background Poland's as well as current external factors.

The historical factor resulted at the beginning of the transformation in 1989 in:

1. banks not being used to assess loan applications
2. banks not being used to deal with small firms

These external factors include:

1. the low level of competition in the banking sector
2. the risk in dealing with smaller firms in general and in dealing with SMEs in a country in transition in particular
3. the availability of other profitable forms of investment
4. low level of information supplied by small Polish firms
5. government regulations regarding corporate tax

When investigating the factors influencing the policies of Polish banks as well as their behaviour with respect to SMEs one has to bear in mind the characteristics of bank under communism, in other words that between the end of World War II and 1989 banks were not allowed to allocate credits to enterprises according to profit orientated decisions but had to follow central directives. As a result, banks had no experience in profit orientated approval of credit applications at the starting point of transformation. They were inexperienced in dealing with small firms, as they almost exclusively, were used to serving large state-owned enterprises. The former, in combination with more and more enterprises experiencing payment problems after the freeing of prices, the reduction of subsidies and the collapse of the RGW market, led to an increasing number of bad loans in Polish banks. The latter might explain why banks do not actively differentiate between small and large firms in the sense of having policies or practices for the SME sector. Another factor is that while the number of banks increased after 1989, the competition in the banking sector remained at a rather low level. Foreign banks, which could have increased the competition in the banking market, showed only a limited interest in the Polish market in the beginning of the reform period because of economic factors, and subsequently because of restrictions introduced by the National Bank of Poland. However, this is likely to change in the future, because market entry barriers for foreign banks will be removed at the latest by the year 2001. In such an environment of low competition it is understandable that the banks are more orientated towards larger firms, not only because they are more familiar in dealing with them but also because profit margins are more attractive and lending to larger firms is likely to be less risky then lending to small firms. Moreover, from 1992 onwards the Polish government issued securities, thus offering banks profitable investment opportunities without any risk involved.

Although the banks will not admit to discrimination against small firms, the effect of the lending criteria which they apply to both small and large firms is to make it more difficult for small firms to raise bank finance than large firms in practise due to size related disadvantages. This is noticeable in the criteria applied in the lending decision of the banks, as well as in the level of collateral demanded and the interest rate charged. The lending decision criteria are mainly orientated at financial ratios, the analysis of the market, the history of the firms in dealing with banks as well as the existence of documents stating that the firm has no liabilities outstanding to the tax office and the national insurance institutions. The trading experiences and the characteristics of the owner-manager, which are of major importance in lending to smaller firms, are missing in the criteria list of the banks. Moreover, Polish banks appear to apply a more capital-gearing approach in lending to small firms, in other words emphasising the value of the collateral provided more than assessments regarding the ability of the firm to service the loan. The level of collateral demanded ranges between 100-500%, although the actual value of securities demanded depends on the liquidity of the collateral, the financial prospects of the firm or the risk involved in the project and the existence of former good co-operation with the customer. Therefore, small firms are likely to have to supply more collateral then larger firms, as they do not offer as many business opportunities as large firms.

Assessment and monitoring cost, which are generally relatively high in dealing with small firms when compared with large firms (because of the fixed cost element) are certainly one of the reasons for this behaviour. However, in the case of Poland factors like a high inflation environment, the fact that smaller firms often only keep insufficient records of the business finances, and trying to hide part of their profits for tax reasons as well as the deficiency of institutions assisting creditors in risk evaluation, certainly adds to the problem. One the other hand, bank managers also appear to lack an understanding of the needs of the SME sector in the first place.

The interest rates applied by banks depend on the risk of the project, the repayment period, the overall profit the bank expects from dealing with the firm and the kind of collateral provided. Small firms, as they are usually more risky and offer less business opportunities when compared with large firms, have to pay higher interest rates when compared with their larger counterparts. For the same reasons, new start ups are likely to face higher interest rates than more established firms. However, it should also be noted that the interest rates applied by commercial banks were relative low in real terms (e.g. when taking the inflation rate into consideration) between 1990 and 1994, sometimes even negative in the cases of prime borrowers. Apparently, even rates charged to small firms were relatively low. By 1997 nominal interest rates for SMEs accounted for between 25 and 30 per cent (between 11,8 and 16,8 per cent in real terms). One reason for the high level of interest rates might be the low level of competition in the Polish banking market. However, the fact that bank have to pay corporate income tax out of nominal profits, with account for a substantial amount in a high inflation environment, might even be of more importance. Indeed, banks in the UK receive higher real interest rates after tax than Polish banks.

7.4 The role of the government and other organisations in relation to the supply of finance to SMEs in Poland.

The main issues regarding the Polish government and other organisation in relation to the supply of finance to SMEs in Poland are as follows:

1. Laissez-faire approach by the Polish government until 1995.
2. First comprehensive SME policy programme launched by the government in 1995
3. Various SME support organisations on regional level, most of which supported by foreign and international organisations.
4. Establishment of a credit guarantee fund in the Bank of the National Economy (BGK), which is administered by 12 large commercial banks
5. Low level of take-up of the credit guarantee scheme provided by the BGK.
6. Financial assistance to SME is mostly provided by foreign and international organisations, especially by PHARE programmes of the European Union.
7. Low awareness about support systems in general among SMEs and well as some support organisations

Until 1995, the Polish government based their economic policy on the neo-liberal doctrine which considers state intervention in the market process as inappropriate. Nevertheless, various SME support organisations were established on a regional level after 1989, such as incubators, business support centres and innovation and technology centres. Many of these organisations were established through alliances including local businesses, community leaders and authorities and most of them were supported by foreign and international organisations. Most widely represented were the Regional Development Agencies (RDAs), the majority of which were set up by a consortium of community governments, agencies, banks and other actors. However, the policy of the government as outlined above and the fact the regional authorities in Poland were not representative of regional interests but responsible for executing legislation initiated by the central government, meant that regional support was also rather weak initially. Moreover, as the majority of the national income in form of taxes and other levies were administered by the central government, the financial means available to regional authorities were limited. The absence of a government policy also led to a lack of co-ordination not only between the various support organisations but also among ministers due to conflicts over competencies.

The Polish government launched their first comprehensive SME policy program in 1995, partly because of Poland's desire to enter the European Community, especially with regard to include the possibility to include Polish enterprises in EC programs (Ministry of Industry and Trade 1995). The policy intended to improve the accessibility for SMEs to financial sources, including legal regulations to stimulate the development of local guarantee and credit funds. This included the further development of the system of credit guarantees for SMEs on the basis of the credit guarantee fund established in the Bank of the National

Economy (Bank Gospodarstwa Krajowego) in 1994 (which is administered by 12 large commercial banks) as well as the development of a credit re-guarantee system for local institutions granting guarantees for SMEs. The Ministry of Industry and Trade took upon the responsibility for SME development and policy, whereas the Polish Foundation for the Promotion and Development of Small and Medium Sized Enterprises had been established by the government to ensure the practical implementation and co-ordination of activities and programmes in this area. However, the financing (which included foreign funds, mainly from PHARE programmes) and the assessment of the policy proved to be difficult. Moreover, co-operations problems between ministers and others involved in the policy influenced the efficiency of the policy in a negative way.

Therefore, financial assistance mostly was provided by foreign and international organisations, especially by PHARE programmes of the European Union, such as the Programme for Structural Development in Selected Regions in Poland (STRUDER) and the Local Initiative Programme. However, these programmes are regionally restricted and many of the other programmes initiated by international organisations were either overly bureaucratic or more interested in larger firms, hence unsuitable for SMEs. Even more importantly, there seems to be a rather low level of awareness about available support measures in general, not only among small firms but also among some support organisation, which might be one of the reasons why the BGK bank received only a few loan applications. On the other hand, considering the fact that the Polish banks are not interested in lending to SMEs, it might be counterproductive to entrust the banks with the decision whether or not a loan application is submitted to BGK. In other words, government intervention in the form of credit guarantees is certainly useful; although banks should not act as "gatekeeper " of the scheme as this appears to influence the number of take ups in a negative way. The Lodz Region Economic Redevelopment Foundation seemed to recognise this, as they started to prepare a local loan guarantee fund which would be provided by the local labour office and their foundation in association with banks, not by the banks alone.

7.5 Recommendations about the types of strategies that could be used to increase the rate of bank finance to SMEs

7.5.1 Recommendations to entrepreneurs

Even though it is a fact that Polish banks are currently reluctant to deal with SMEs, owner-managers can contribute to increase their accessibility to external finance. **The key finding for Polish entrepreneurs to is to focus on their relationship with the supplier of credit.** Business people should think of managing the "finance supplier (bank) relationship" in the same way that they think of managing suppliers and customers - as an essential business/management task that has its own demands and skills as well as benefits.

These include:

Understanding the position of banks

Entrepreneurs should:

- acknowledge that the position of banks in the economy has changed, that banks are now commercial businesses, depending on profit, and not administrators of the financial system on behalf of (and subsidised) by government.
- understand the difficulties banks are facing, not only with respect to external factors such as the inflation rate but also regarding their difficulties in dealing with SMEs, especially the higher level of risk and associated higher costs for the bank.
- realise that the above point is even more problematic for Polish banks, when compared to foreign credit suppliers, as after 1989 Polish banks had not only to learn how to assess credit applications but also how to deal with the small business sector in general.

In practical terms, this means that Polish owner-manager should change their attitude with regard to suppliers of external finance. Furthermore, entrepreneurs need a better understanding of the way market economies function (e.g. the importance of the inflation rate) and of the role of banks in this system.

Contribution to the bank relationship

Entrepreneurs should:

- contribute to reduce the information asymmetry that exists between the banks and the firms, therefore reducing the lending risk for the bank by:

    * reducing the level of costs involved in assessing their loan application by providing the bank with more detailed information.
    * developing a closer working relationship with the bank or loan manager and seeing this as a long term relationship, not one defined only by momentary financial needs.

In practical terms this means that Polish entrepreneurs should apply more sophisticated accounting system (i.e. not only keeping an records of sales), even though this might not be required by law, in order to be able to provide the bank with more accurate financial information. This might require some training for the owner-managers of Polish firms.

Through a better relationship between Polish entrepreneurs and the banking sector can lead to:

- an increase in the rate of bank finance to the SME sector
- more favourable conditions of external finance once bank finance has been approved
- more realistic expectations among SME owner-managers with regard to the terms of bank finance, thus enabling small firms to plan investment projects more efficiently.

However, even though banks in Poland are now commercial businesses, their attitude towards small firms has not changed significantly, in other word, they are currently not very interested in dealing with SMEs. Therefore, the improvements listed above are probably rather limited. As SMEs are unlikely to be in the position to influence the behaviour of the banks, they should consider their strength with regard to their growing importance in the economy, hence try to influence government policy towards providing better access to external finance. Therefore, they should organise themselves in associations on local, regional and national level, thus creating a combined force to represent the SME sector to the state.

7.5.2 Recommendations to bank manager

The key findings for Polish banks are based on the fact that:

(i) competition in the banking sector will increase as soon as market entry barriers for foreign banks are liberalised in the year 2001.

(ii) the private sector becomes increasingly important in the Polish economy.

(iii) the private sector consists mainly of small firms.

Therefore, banks should:

- eliminate their old way of thinking (which is still present from the communism period were banks did not used to lend to SMEs) and regard the small business sector as an important sector of the lending market.
- make a clear decision whether to enter and develop the SME market or to concentrate on other market sectors.

Strategies for banks that want to penetrate and develop the SME market:

Lending policy for SMEs

Bank should:

- recognise the special requirements of SMEs
- provide a wider range of services that address the needs of these firms
- develop a better understanding of small businesses in market economies

Lending criteria for SMEs

Bank should:

- consider the trading experience of the owner-manager as critical in the lending decision to small businesses.
- consider the ability of the entrepreneur to run a business under the condition of a market economy, hence the ability of the owner-manger to find customer for his/her products or services.
- realise that it is most important that the owner-manager of the small firms has the ability to do what he says he will do.

In this respect, banks should also shift from a "collateral based" lending to a more "income base" lending, because:

- collateral does not prevent the banks from the risk of adverse selection (the possibility to fund non viable projects)
- the "income base" approach reduces the risk of adverse selection for the bank, as it concentrates more on the expectation whether or not the firm would be able to serve the loan.
- it increased the accessibility of bank finance for SMEs with viable projects, as the level of collateral demanded by the banks would be lower (which is the main barrier for small firms seeking bank finance). Therefore, it increased the number of viable projects in the customer portfolio, hence the profitability of the banks.

Working relationship with SMEs

A good and long-term working relationship with small firms is desirable for banks, as this might reduce the information asymmetry between the bank and the firm, hence reducing the assessment and monitoring costs for the bank.

Banks should:

- establish small business departments (as has been done in the major banks in the UK) or, in the case of smaller banks, assign special loan manager trained in dealing with SMEs

As a result, banks could organise credit approval in a less bureaucratic manner (for example setting a maximum amount up to which the loan manager is allowed to approve credit applications), hence make use of the fact that the manager dealing with the owner-manager of the firm is most likely to be the best person to assess the creditworthiness of the firm.

Training needs to understand SMEs

To train bank managers and bank staff with regard to the specific characteristics and needs of Polish SMEs in the new market economy is one of the key factors for banks to apply lending policies and criteria designed for SMEs and to establish good working relationships, if they are to be successful in dealing with the small business sector.

Loan Guarantee Schemes for SMEs

In order to increase their market share in the SME sector, banks could make more active use of Loan Guarantee Schemes, as:

- bank themselves report about the lack of assets of SMEs to be used as collateral
- collateral requirements one of the main barrier of bank finance to SMEs
- the need for banks to require collateral from firms to secure loan might be reduced if banks apply a more income-geared lending approach, however is unlikely to be eliminated completely as information asymmetries are unlikely to be completely eliminated, especially in cases where the firms has no credit history (such as in the case of start ups).

Therefore, banks should:

- co-operate with providers of Loan Guarantee Schemes for SMEs or even administer such schemes.
- inform small business owner about the availability of such schemes.

7.5.3 Recommendations to policy makers

The key findings for Polish policy makers to increase the rate of bank finance to SME focus on the provision of a stable economic environment and a regulatory framework as well as direct intervention in the financial market in forms of support programmes.

One of the main responsibilities of the government is to provide a stable economic environment and a regulatory framework which encourages the development of businesses.

These include the:

Inflation rate

A low and stable inflation rate is necessary for all parties in the economy to calculate costs and risks of doing business on a long term basis, hence is needed to provide the basis for economic growth. Even though the inflation rate has been significantly reduced since 1989, it is still too high when compared with more mature market economies.

Infrastructure

- Polish SMEs, in terms of their growth potential and their personal ability could well be of interest to informal venture capitalists.
- Owner-managers of small firms are interested in venture capital.
- In Poland, a stock market for SME shares does not exist, whereas two markets aiming at small firms are operating in the UK since 1995.

Therefore, policy makers should:

- establish an exit route for venture capitalists, by creating a stock market designed for dealing with SME shares.

Regulations

Policy makers should:

- eliminate regulations that lead small businesses towards bootstrapping measures (e.g. high level of tax lead to small businesses have to hide part of profits in order to survive, and consequently have problems raising bank finance as banks can only use official profit data)
- reconsider their regulations regarding corporate tax allowances for the inflation rate. Currently, banks have to pay corporate tax out of nominal interest rates, which (especially in a high inflation environment) increased significantly the level of interest rates banks have to charge their customers in order to receive positive real interest rates after tax.

Public support programmes constitute direct intervention in the market, therefore need justification.

In the study the justification for policy support with regards to the supply of finance for SMEs rest on three main arguments:

(i) **The majority of Polish small firms applying for debt finance are growth orientated.**

SMEs have the potential to contribute in various ways to the development of the private sector in Poland, including contributing to employment generation.

(ii) **The Polish banking sector is protected form foreign competition by the government.**

The introduction of market entry barriers is understandable considering the need to allow the domestic banking sector to develop to a level that banks can compete with foreign competitors in a free market economy. However, this leads to size related disadvantages for smaller firms, as the low level of competition in the Polish banking sector encourages banks to continue to concentrate on dealing mainly with larger firms to whom they are used to from the communist period. Consequently, small firms experience difficulties in accessing bank finance, with might lead to viable projects not being funded. This again puts jobs at risk as well as delays and hinder the development of new employment.

(iii) **Polish banks are unlikely to sufficiently meet the financial needs of SMEs, even if they start serving the small business sector.**

Information asymmetries between the bank and the small firm can't be eliminated and the fact that loan assessment and monitoring cost are higher for banks when dealing with smaller firms compared with larger firms, requires public support programmes even in market economies with banks interested in SMEs such as the UK and Germany.

Experiences with current financial support programmes show that those involved in the development of such schemes need to be more aware of the financial needs of SMEs as well as of suitable distribution and information channels to maximise the impact of the programmes.

Qualifying criteria of public support programmes

Policy makers should:

- investigate the need of SMEs regarding external finance. For example, firms employing up to 5 persons appear to be most constrained by a shortage of finance, hence need support programmes offering smaller amounts of finance.

Distribution of public support programmes

Policy makers should:

- take into account the current lack of interested of banks in dealing with SMEs when looking for suitable channels of distribution for support programmes. Banks, even so they should be involved in such

schemes as potential source of funds, should not act as "gatekeeper " of the scheme as this appears to influence the number of take ups in a negative way.

- consider entrusting other organisations outside the banking sector with the administration of financial schemes, as it is the case in Hessen (Germany). The existing Regional Development Agencies could be a starting point for such a network of organisations, as they are represented throughout the country. However, it would be necessary to ensure that those dealing with the support applications are properly trained in assessing the proposal, in order to avoid the experience the banks made in the early years of transition with bad debts. It might be possible to draw on the expertise of foreign support organisation that are already active in Poland.
- co-ordinate existing loan guarantee schemes into larger funds which could be administered via small business support or/and regional development agencies. This might be more effective (e.g. in terms of promoting the schemes) and might even be more interesting for banks to co-operate with.

Information about public support programmes

Policy makers should:

- inform small firms as well as support agencies about available programmes. This demands efficient channels of information between the issuer of the support programme, the organisations involved in the administration of the scheme, as well as other business advisers, banks and small firms.

7.6 Conclusion

The conditions for Polish SMEs with respect to accessing bank finance have certainly improved since the beginning of the reforms in 1989. The creation of two-tier banking system led to the establishment of commercial banks which are managed according to market economy rules, in other words operate profit-orientated. A more stable macroeconomic environment led to an decrease of the inflation rate, which the banks passed on to their customers in form of lower interest rates. Moreover, in an attempt to distinguish more successfully between sound and unsound credit applications, Polish banks have improved their lending decisions over the last years. However, the level of competition within the banking system is still low and, even more important, institutional changes proved to be more easily achieved than changes in the attitudes of Polish banks. As a result, banks are still reluctant to deal with small firms, hence don't apply policies designed for lending to smaller firms. Therefore, small firms are still being discriminated against larger firms with respect to the availability of debt finance as well as with respect to the conditions of available credit (the level of interest rates and collateral). Government efforts to increase the accessibility of small firms towards external finance have been only of limited success, partly because such schemes were distributed via the banking system. Therefore, financial assistance was mainly provided by foreign and international organisation. However, such funds were often regional restricted or proved to be unsuitable for smaller firms. Consequently, is appears that the Polish SME sector still has only limited access to external finance, especially microenterprises and start ups.

Efforts to improve the financial market for SMEs in Poland have to come from the banks, owner-managers of SMEs and the government in combination with other organisations set up to support the SME sector.
It is understandable that banks will only increase their interest in dealing with SMEs should this be profitable for them. However, as the SMEs sector becomes increasingly important in the Polish economy and the competition in the banking sector is expected to increase in the near future, it is likely that in future banks will recognise the SMEs sector as potential market. Nevertheless, in order for banks to deal with small firms effectively, small firms need to contribute to a good working relationship with the bank, among others by providing more accurate financial data about their businesses. The government, on the other hand, should make sure that Polish banks will be able to compete against future foreign competition by further stabilising the macroeconomic environment and by providing a framework of regulations (e.g. with regards to tax-regulations) similar to those applied in more mature market economies. Moreover, considering the high interest of Polish SMEs in venture capital, the government should establish an exit route for shares of small businesses. Even though the interest of small firms in venture capital is likely to decrease as soon as debt finance becomes more easily available, informal venture capital could still pay a significant role in the supply of equity finance to Polish SMEs.

As changes within the banking system are unlikely to happen in the short-term, further support for the SMEs sector is needed to increase the accessibility of external finance in the meantime. However, public support programmes must take the needs of Polish firms into account (e.g. the amounts of finance needed by small firms) and should consider the lack of interest of banks in dealing with SMEs, hence should be distributed via organisations set up to support the Polish SMEs and not via the banking system.

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APPENDIX I: PUBLIC SUPPORT PROGRAMMES IN POLAND

BGK loan guarantee programme

The programme has been established by the Polish government and is administered by Bank Gospodarstwa Krajowego (BGK) in co-operation with 12 large commercial banks. It was funded by the Polish Ministry of Finance with PLN 45 million and aimed to support SMEs to increase export sales, to introduce new technology and for certain other purposes. The program guarantees up to 60 per cent of the loan The collateral requirement is 50 per cent of the guaranteed portion of credit
the fee is 1.2 per cent in the first year and an additional 0.2 per cent each year thereafter
(Suzuki 1996)
Comments: Useful for SMEs, provided the involved commercial banks are interested in dealing with SMEs.

STRUDER programme

The Programme for Structural Development in Selected Regions in Poland (STRUDER)
was implemented by the Polish Agency for Regional Development (PARD) in April 1994.
Among others STRUDER provides financial support for SME creation and development in form of a grant scheme in six selected provinces of Poland. The main source of funding is the PHARE programme of the European Union. SMEs can apply for the grant in Regional Development Agencies (RDAS) in each of the six regions The grant is a non-repayable grant of up to 25 per cent of the cost of investment in mainly fixed assets. A minimum of 20 per cent has to be contributed from the entrepreneur's own resources (a minimum of 15 per cent for projects over 200 000 ECU) with the balance coming either from more of the entrepreneur's own resources or from bank credit. The maximum level of grant for any one project is 100,000 ECU.

To be eligible for the grant, firms have to:

- be privately owned
- employee no more than one hundred employees.
- be active in the manufacturing or service sector, including transportation, tourism and agribusiness.
- locate the investment (fixed assets only) in the region only
- demonstrate sound management and evidence of project viability
- have no tax or social security indebtedness

At the end of April 1995 grants for over 200 projects had been approved, totalling nearly 7 million ECU. The total investment by the SMEs involved (all of which employ less than 100 people) accounted to almost 30 million ECU in some of the most disadvantaged regions in Poland.
Comment: Scheme appears to be overly bureaucratic for the smaller investment projects.
(Kozak 1996)

The Polish-British Enterprise Project (PBEP)

A regional development programme financed by the UK Know-how Fund. Total funding is US$2 million from the Interest Account in Stabilisation Fund, to which the British government contributes. PBEP started in autumn 1994 to provide an integrated programme of support for SMEs. Two provinces (voivodships) in eastern Poland Lublin and Bialystok have been selected for this programme. The five-year project combines technical assistance with funding of financial and enterprise support instruments. Among others, the fund guarantees up to 70 per cent of bank loans. The maximum size is US$ 70,000 and maturity is up to five years. The fee is on per cent of the guaranteed portion .

(Suzuki 1996)

Comments: Useful for SMEs, however regional restricted.

Loan of Polish American Enterprise Fund

Responsible organisation:	Polish-Hungarian Enterprise Fund
Duration:	max. 3 years
Interest:	12 per cent
Repayment free period:	5 months
Security:	no info
Own capital:	no info
Max. Award:	500,000 US$
Assisted firms:	2,600
Credit volume paid:	62 million US$
Comments:	Positive assessment due to otherwise lacking short- and medium-term financing opportunities for SMEs

(RWI 1994 b)

Bank for Social and Economic Initiatives (BISE)

Responsible organisation:	Bank for Social and Economic Initiatives (BISE)
Duration:	no info
Interest:	no info
Repayment free period:	no info
Security:	no info
Own capital:	no info
Max. Award:	2 billion zloty
Assisted firms:	no info
Credit volume paid:	no info
Comments:	1991: 8,000 jobs in SMEs. High efficiency through close co-operation with FISE

(RWI 1994 b)

EIB Loan (EIB = European Investment Bank)

Responsible organisation: EIB / Polish Development Bank
Duration: 4 - 14 years
Interest: EIB interest rate plus bank margin
Repayment free period: Maximum 4 years and 8 months
Security: no info
Own capital: no info
Max. Award: 10 million US$
Assisted firms: All World Bank and EIB projects: 177 applications of which 31 approved
Credit volume paid: 75 million ECU (available)
Comments: Irrelevant for SMEs as mainly considered for large investment projects
(RWI 1994 b)

PHARE Local Initiatives programme

Responsible organisation: PHARE / Co-operation Fund
Duration: 1 - 7 years
Interest: LIBOR plus 3 - 4 per cent
Repayment free period: 2 years
Security: no info
Own capital: no info
Max. Award: 250,000 ECU
Assisted firms: 43
Credit volume paid: 3.14 million ECU

The programme is active in eight communities. The programme provides loan guarantees, loans, equity investment, education and training, assistance for the development of business support and incubation centres. Total budget is ECU 7.5 million. In 1994, the budget for guarantees was PLN 2.5 million. Businesses in the agricultural sector are eligible. Businesses must employ fewer 50 persons, have net sales of less then ECU 1 million, and be at least 51 per cent privately-owned.

Comments: Despite guarantee option, highly unsatisfactory flow of resources due to problems with the managing bank and because of regional restrictions
(RWI 1994 b, Suzuki 1996)

PHARE Equity programme

Responsible organisation:	PHARE / Co-operation Fund
Duration:	at least 60 months
Interest:	N.A.
Repayment free period:	N.A.
Security:	N.A.
Own capital:	N.A.
Max. Award:	Max. 15% equity or 200,000 ECU
Assisted firms:	0
Credit volume paid:	2 million ECU
Comments:	Only available for those firms which have received EIB loans. Small flow of resources as the involved Export-Development Bank is mainly orientated to state companies

(RWI 1994 b)

World Bank loans for the development of the private sector

Responsible organisation:	World Bank / Polish Development Bank
Duration:	Maximal 7 years
Interest:	LIBOR / FIBOR plus bank margin
Repayment free period:	Maximal 3 years
Security:	no info
Own capital:	50 per cent
Max. Award:	2 - 4 million US$
Assisted firms:	All World Bank and EIB projects: 177 applications of which 31 approved
Credit volume paid:	55 million US$ (available)
Comments:	Overly bureaucratic, as loan application only given following agreement with World Bank

(RWI 1994 b)

World Bank loan for privatisation and restructuring

Responsible organisation:	World Bank / Polish Development Bank
Duration:	Maximum 12 years
Interest:	LIBOR / FIBOR plus bank margin
Repayment free period:	Maximum 1/3 of duration
Security:	no info
Own capital:	50 per cent
Max. Award:	10 million US$

Assisted firms:	All World Bank and EIB projects: 177 applications of which 31 approved
Credit volume paid:	125 million US$ (available)
Comments:	Irrelevant for SMEs, as mainly large privatisation projects considered

(RWI 1994 b)

Equity funds funded by the European Bank for Reconstruction and Development (EBRD):

Alliance Scan East Fund

The Fund makes equity investments in companies in which one of the industrial partners invests at the same time. Industries covered by the industrial partners are: telecoms, cables, construction materials, pulp and paper equipment, power generation, environmental technology, petrochemicals and plastics, oil and gas. It may invest in any of the EBRD's countries of operations.

Alliance ScanEast Fund
Aleksanterinkatu 15B
EastMan Advisors OY
00100 Helsinki, Finland
Contact: Mr Ari Tolppanen, Chairman
Tel: +358 9 615 58 00
Fax: +358 9 615 58 300
(EBRD Internet Home Page May 1998)
Comments: Unlikely to be suitable for SMEs

East European Food Fund

This fund undertakes equity and equity-related investments in the food and beverage industry. Investments range from US$ 2 million to US$ 7 million. Although the Fund may invest in most of the Bank's countries of operations, it intends to focus its investments in Belarus, Bulgaria, the Czech Republic, Hungary, Poland, Romania, Russia, the Slovak Republic and Ukraine.

Jupiter Asset Management Limited
Knightsbridge House
197 Knightsbridge
London SW7 1RB
United Kingdom
Contact: Mr Laurie Cannon, Director
Tel: +44 171 412 0703
Fax: +44 171 581 3857
(EBRD Internet Home Page - May 1998)
Comments: Unsuitable for SMEs as investment start from US$ 2 million

Renaissance Fund

This fund considers investing in emerging private enterprises, including start-up and young growth companies, management buy-outs and spin-offs of small state-owned businesses. It makes initial investments in the range of US$ 100,000 to US$ 500,000, and follow-on investments will be made as appropriate, with ultimate portions being in the range of US$ 1.5 million to US$ 2.5 million. This fund can invest in the Czech Republic, Poland and the Slovak Republic.

Renaissance Fund, Warsaw Office
Renaissance Partners
ul. Lowicka 44
02-551 Warsaw
Poland
(EBRD Internet Home Page May 1998)

Comments: Might be suitable for medium sized enterprises as investments start form US$ 100,000

Caresbac Polska SA

This fund is particularly interested in existing companies in the agricultural and ancillary sectors. It makes investments on commercial terms in companies with at least 51 per cent Polish ownership, promising strong long-term business growth. Investment range is from US$ 75,000 to US$ 400,000.

Caresbac Polska SA
ul. Polna 40
00-635 Warsaw
Poland
Contact: Mr Piotr Kalaman, Director General
Tel: +48 22 25 62 05/25 62 06/ 25 62 16/25 62 17
Fax: +48
(EBRD Internet Home Page - May 1998)
Comments: Suitable only for SMEs in agriculture

Pioneer Investment Poland

This fund invests in private companies and companies undergoing privatisation in Poland. Main areas of interest are: food processing, construction materials and services, leather, wood production, distribution and retailing, transport, telecommunications and the computer servicing industry. Investments range from US$ 500,000 to US$ 9 million.

Pioneer Investment Poland
INTRACO
ul. Stawki 2
00-193 Warsaw
Poland
Contact: Mr David Hartford
Tel: +48 22 860 6600
Fax: +48 22 860 6601
(EBRD Internet Home Page - May 1998)
Comments: Only for companies undergoing privatisation - more likely to be larger companies

Poland Investment Fund (Advent Fund)

This fund provides finance and management assistance to companies in the private sector. Investments range from US$ 1 million to US$ 8 million. The Fund finances projects in the Czech Republic, Hungary, Poland and the Slovak Republic. Please see listings below for individual fund addresses.

Advent Fund
123 Buckingham Palace Road
London SW1W 9SL
United Kingdom

Contact: Mr Nicholas Callinan, Managing Director
Tel: +44 171 333 0800
Fax: +44 171 333 0801

Poland Investment Fund (Advent Fund)
Copernicus Capital Management Sp. z.o.o.
Krakowskie Przedmiescie 79
00-079 Warsaw
Poland

Contact: Mr Neil Milne, Managing Director
Tel: +48 22 26 85 80/26 64 32
Fax: +48
(EBRD Internet Home Page - May 1998)

Comments: More for medium sized and larger firms as investment start at US$ 1 million

DBG Osteuropa Holding GmbH

This fund invests capital in local companies as well as joint ventures in the four Visegrad countries. Typical investments range from US$ 5 million to US$ 10 million.

DBG Osteuropa Holding GmbH

Jungmannova 34

11000 Praha 1

Czech Republic

Contact: Mr James O'Neil, Chief Executive Officer

Tel: +420 2 2409 8400

Fax: +420 2 2409 8444

(EBRD Internet Home Page - May 1998)

Comments: More for larger firms as investments start from US$ 5 million

Polish Private Equity Fund

EBRD equity participation

The fund is interested in new businesses ventures, small and medium-sized privatisation or restructuring and joint-ventures with foreign partners. In selected cases, it can provide debt financing in addition to equity. Investments range from US$ 500,000 to US$ 10 million.

Polish Private Equity Fund
Enterprise Investors
ul. Nowy Swiat 6/12
00-400 Warsaw, Poland
Contact: Ms Barbara J Lundberg, Executive Vice President/General
Director of the Warsaw Office
Tel: +48 22 625 1868
Fax: +48 22 625 7933
(EBRD 1996)

Comments: More for medium sized and large companies as investment start from US$ 500,000

Baring Communications Equity Emerging Europe

This fund considers equity investments in emerging private enterprises in the media and communications industry. It focuses its investments in companies operating in Poland, Czech Republic, Slovak Republic, Hungary, Baltic states, Slovenia, Russia, Ukraine, Croatia, Romania, Bulgaria and the EBRD's other countries of operations. The preferred investment size is from US$ 1 million to US$ 5 million. However, smaller or larger investments are considered on a case-by-case basis.

Baring Communications Equity Emerging Europe
Warsaw Office
Vl. Chocimska 28, p.V #531
00-791 Warsaw
Poland

Contact: Ms Heather Potters, Partner
Tel: +48 22 627 4156
Fax: +48 22 492 784

Comments: More for medium sized and larger companies as investments start from US$ 1 million

APPENDIX II: CASE STUDY TOPIC GUIDE

A. Firms that were successful in obtaining bank finance

1. Introduction

Name of the firm:

Address:

Name of the interviewee:

Position of the interviewee:

Interpreter:

Date of Interview:

2. What are the main problems for your business at present?

3. What were your main resources of capital at the time the business started and what were your main sources of finance since then?

Probe for percentages: Personal savings, capital from previous, family or friends, bank loan/credit, other loan (specify), foreign investment, domestic equity partners, subsidies/loans (specify).

Bank loan: when received?

4. What are your experiences with bank loans?

How did you start the approach?

Probe: Use of any business adviser (name),advise useful?, name of bank, since when existed bank(site), former contact with bank manager, nature of that contact. Personal or business account with the bank?

What was offered by the bank?

Probe: Overdraft loan, term loan (maturity period), interest rate - fixed (years) or floating (how calculated), was it possible to chose the type of interest rate?, if loan has not been paid back yet - what is current interest rate, are interest rates reasonable? If no-what would be reasonable? Change of sales prices of their products in the last year in percent?

What did the bank require from you?

Probe: Details about the firm (turnover, management structure, business plan, book-keeping etc.), securities (collateral, references, etc.), what kind of collateral, what value of collateral (too high?)., difficulties in providing the collateral, charges required by the bank, were charges appropriate, main point banks are looking for when deciding whether to grant a loan or not?

What are your main problems in dealing with the bank?

Probe: Bank reluctant to lend to SMEs, complicated procedure, approval by the bank took too long (what problems caused that? - need to find other short-term finance, delay in expansion, etc.).

5. What are your experiences with external equity?

Did you ever rise external equity or would you like to raise any? , if yes where, main problems with external equity (not available, application to complicated, loss of control over the company)

6. What are your experiences with business adviser or/and external support schemes with respect to raising external finance?

Used any, names, useful - in what way, if not useful why not?

B. Firms that were not successful in obtaining bank finance

1. Introduction

Name of the firm:

Address:

Name of the interviewee:

Position of the interviewee:

Interpreter:

Date of Interview:

2. What are the main problems for your business at present?

Financial problems (specify), how is the business effected by these financial problems?

3. What were your main resources of capital at the time the business started and what were your main sources of finance since then?

Probe for percentages: Personal savings, capital from previous, family or friends, bank loan/credit, other loan (specify), foreign investment, domestic equity partners, subsidies/loans (specify).

4. What are your experiences with bank loans?

How did you start the approach?

Probe: Use of any business adviser (name),advise useful?, name of bank, since when existed bank(site), former contact with bank manager, nature of that contact. Personal or business account with the bank?

For what kind of loan did you apply?

Overdraft loan, term loan (maturity period) ?

Why did you not receive the loan?

Bank refused to give it or did you not want it any more?

Possible reasons:

Interest rate	What did the bank require, what would you have been accepted?
Kind of collateral	What was required, what would you have been willing to give? - Problems to provide the kind of collateral required?
Value of collateral	What was required, what would you have been willing to give?

5. What are your experiences with external equity?

Did you ever rise external equity or would you like to raise any? , if yes where, main problems with external equity (not available, application to complicated, loss of control over the company)

6. What are your experiences with business adviser or/and external support schemes with respect to raising external finance?

Used any, names, useful - in what way, if not useful why not?

APPENDIX III: KEY INFORMANT TOPIC GUIDE - BANKS

1. Introduction

Name of the bank:

Status of the site:

Headquarter, branch

Address:

Name of the interviewee:

Position of the interviewee:

Date of Interview:

2. What is the lending policy of this branch?

Lending portfolio, amount of total lending, percentage of lending to SMEs in total lending. To what extend is the lending policy dictated by the headquarter? - What is decided by the branch? Are SMEs a special target group of the lending policy? Do you distinguish between different SME-groups in your lending policy? (Specify)

3. What is your lending policy toward SMEs?

What criteria are you using in the decision whether to lend to an SME or not?

How do you assess the credit worthiness of SMEs? (Cash-flow, turnover, prospects of the project -how is that assessed? market research, help of other institutions, own expert, - documents of the tax office and the national insurance institute, book-keeping records, business plan, profitability, account history etc. What is you first and you second criteria in your lending decision?

What kind of collateral and what value do you require?

Business premises, private houses, cars, machinery, etc. How do you assess the value of the collateral? (own expert, external expert visit firm, compare with market value) If collateral >= 100 %, why is such a high level of necessary for the bank?

What interest rate do you require from SMEs?

What do you use as base rate? (Lombard, discount, WIBOR, other (specify) What margin do you require, how are these margins calculated (maturity period, evaluated risk of the project, etc.) Do you require different margins from different type of SMEs? (age of firm, number of employee etc.)

What is the decision procedure?

Who decides (at branch or at headquarter)? Manager (what manager), group of manager (specify) etc. How long does the decision in average take?

4. What are your experiences in lending to SMEs?

Main problems (repayment, bad loan, percentage of bad loans in total loans to SMEs) Monitoring of the firm, how is that done? Problems with collateral ? Does the new collateral law from December 1996 help to improve the lending to SMEs? Problems with a specific group of SMEs? - specify How would you describe the relationship between you and the SME-manager? (tension? . long-term relationship? Good flow of information?)

5. Former surveys have shown that banks only play a minor role in the finance of business start ups as well as in further investments of SMEs. What is in you opinion the reason for that?

SMEs to risky to lend to. What could SME manager do to increase bank lending? What could the government do to increase bank lending? (credit guarantee schemes etc.)

6. Do you offer any other services apart from loans to SMEs?

Product and market information, information about government and other grants, equity finance, etc.

APPENDIX IV: KEY INFORMANT TOPIC GUIDE - BUSINESS ADVISER

1. Introduction

Name of the institute/organisation

Address

Name of the interviewee

Position of the interviewee

Date of the interview

2. To what extent do SMEs use your service?

How many firms use your service at present? How many of these are SMEs? (If only as few what do you think is the reason for that?) How many of the SMEs who use your service require support in getting external finance? How do you get in contact with SMEs? (active - advertising specially of SMEs etc. of passive - wait for SMEs to contact them)

3. What kind of support for SMEs seeking external finance do you provide?

Support = information, advice, other?

Support area = sources of finance (bank, international or national programmes etc. - specify), different types of finance (loan, equity, other - specify) - what is most suitable for the firm, requirements needed to access these funds, filling in of application forms, calculation of cost of finance for the firm, business plans, etc.

Support schemes specialised for SMEs? Schemes distinguishing between different groups of SMEs (which - size, sector, age, etc.)?

Support free of charge? (if no, what do you charge?)

4. What are your experiences in dealing with SMEs?

Which of the services is most required by SMEs?

Do different SME-groups (size, manufacture/service, age etc.) require different services - if yes, which group requires what?

What do you think are the main problems SMEs have with respect to external finance?

What do SMEs complain about most, what is their attitude towards banks (sceptical or trust them).

Which type of SMEs are most successful in getting external finance, esp. bank finance, do firms who got more than one bank loan find it easier to get the second one, compared to the first one?

What are your main problems in dealing with SMEs?

They do not know what they want, have unrealistic ideas about external finance (specify), etc.

5. **How would you assess the attitude of banks towards lending to SME's?**

Not interested in lending to SMEs (why), prefer certain types of SMEs (which).

Has the institute/organisation any contacts to banks? (what is the nature of that contact).

How would you describe the relationship between bank managers and SME managers (tension, good flow of information, SMEs reluctant to give information about their business, bank managers are not interested in contact with SME managers, do long-term relationships exist or do SME managers tend to change their bank quite regularly)?

6. **Former surveys have shown that banks only play a minor role in the finance of business start-ups as well as in further investments of SMEs. What, in your opinion, is the reason for this?**

Bank can make money with other investments (treasury bills etc.), etc.

7. **What could be done to improve bank finance to SME's?**

by SMEs (better flow of information, better financial management, etc.)

by banks (offer additional services to SMEs (what), acknowledge SMEs as a target group, etc.)

by the government (credit guarantee schemes, co-ordination of support institutions, lease or sale of property under special conditions, providing better laws (what), etc.)

New collateral law from December 1996 - did this have any influence on banks lending to SMEs?

How should the support be delivered? (by the government or rather through non-state institutions, e.g. chambers, as SME managers may be sceptical about any governmental institutions.)

APPENDIX V: PROFILES OF CASE STUDY FIRMS

Case 1

Firm 1 is a furniture manufacturer founded in 1982 by two partners. In 1995 they employed eight persons on a full time basis, at the time of the survey only one full time employee was left and the income was just enough to cover the costs. The main problems as quoted by the owner-manager are the low level of demand as well as delayed payments from customers. Being in business for so long. He could not remember how the start up of the firm was financed. At the time of the interview only internal sources of finance were used. The owner had applied for a loan at his bank, however did not succeed in obtaining it.

Case 2

This partnership consists of two persons and started trading in August 1991. They manufacture kitchen furniture and also have three retail shop through which part of the furniture is sold. Although having been successful in obtaining three loans between 1992 and 1993, they could not obtain another loan in 1997. One of the partners mentioned the lack of external finance as the main barrier for the development of the firm. The start up of the firm was entirely financed with personal savings and at the time of the survey the firms had to relied to 100 per cent on retained profits.

Case 3

Firm 3 manufacturing cookies and ice-cream started trading in August 1945. The products are sold through wholesale companies as well as through a small retail shop which belongs to the firm. Although being successful in receiving a loan from western credit lines in July 1991, the owner-manager experienced problems with new custom regulations when he tired to import machines he bought with the credit in Denmark. In 1992 the loan was taken over by a Polish bank, which whom the owner established a good working relationship.

Case 4

Seven partners established this firm in 1994, six natural persons and one firm. The main activity is the production of parts for hydraulic machines. Initially, the main problem of the firm was consisted of financial constrains, as they were unsuccessful in obtaining a bank loan. Nevertheless, they received a bank loan in 1995 and enjoyed the an overdraft limit on their bank account at the time of the interview. They could even have received a loan from the STRUDER foundation, however did not take the opportunity because of internal management problems.

Case 5

This firms started trading in 1992 and manufactures clothes. The owner-manager obtained a bank loan for the start up of the firm, accounting for 30 per cent of the resources. In the years to follow he received short-term loans every year. At the time of the interview, the financial resources of the firm consisted mainly of retained profits and personal savings. However 10 per cent were covered through leasing arrangements and

5 per cent consisted of credits. The main problem, as quoted by the owner, was to obtain long term finance to build a production plant.

Case 6

The owner-manager of firm 6, a food producing company founded in 1990, cited unstable prices of raw materials as main problem. He also complained about the low level of information available for subsidised credits. The start up of the firm was financed entirely with internal sources. At the time of the survey the business was still mainly relying on internal finance, however a few machines were leased. The owner obtained a loan between start up and September 1997 but was unsuccessful when applying for a subsidised loan which was provided by the European Union in 1996.

Case 7

This firm manufactures furniture, mainly kitchen furniture. The main problem for the firms is that they are producing high quality products for which the market is rather small, especially in Lodz. The owner complained also about unfair competition form foreign firms, because of tax advantages they receive, and about difficulties in obtaining external finance. The father of the current owner founded the firm in 1985 entirely with internal funds. At the time of the interview, between 12 and 13 per cent of the annual turnover was financed with external funds. The owner received the first loan in 1991 from a western credit line and enjoyed three loans form different banks in September 1997.

APPENDIX VI: KEY INFORMANT INTERVIEWS

A. Banks

Bank 1

Bank 1 has five branches and is mainly owned by a capital group from the Czech Republic, who at the time of the interview had just taken over the majority stake of the bank. One of the minority owner is the Lodz Province, holding about 6 per cent of the ownership.

Bank 2

Bank 2 is one of specialised state banks that were active during the communism period. It had been merged in November 1996 with three other stated banks into a large group, however remained entirely state owned.

Bank 3

Bank 3 is of mixed ownership. The majority stake of the ownership is hold by one of the state owned banks. Other shareholder are Polish public organisations as well as Polish and foreign firms. The bank holds 54 branches.

Bank 4

Bank 4 is one of the regional state banks that merged in 1996 into Bank Pekao SA, hence is entirely state owned.

B. Business adviser

Lodz Region Economic Redevelopment Foundation

The foundation, a local government organisation, was established in 1993 in order to provide financial and advisory services for the redevelopment of the Lodz region. In 1992/93 the foundation was mainly concerned with the restructuring of large state owned enterprises, as these had a major impact on the labour market. More recently, they are also organised projects aimed to support smaller firms, such as training courses for entrepreneurs and the participation of small Polish firms in foreign trade fairs. They also took part in the establishment of Enterprise Supporting Centres in Lodz and Sieradz. At the time of the interview the foundation was in the process of preparing a loan fund aimed exclusively at SMEs. The project was planned together with the local labour office. The foundation co-operates with various other government institutions as well as non-government organisations, e.g. the Lodz Incubator. In fact, one member of the foundation is on the board of directors of the Incubator institution. Part of the activities of the foundation were funded by foreign organisations, for example the Know-how Fund, the European Union (PHARE programmes) and the World Bank.

Chamber of Commerce in Nowy Sacz (South Poland)

The Chamber of Commerce (CCI) gives advice and information for entrepreneurs, both to members and non-members. The membership for entrepreneurs at the CCI is voluntary. 18-20% of their members are SMEs employing up to 99 persons Sometimes banks asked to become a member, because that indicates that they are part of the business community. The CCI is well known in the community. They have a monthly bulletin, place articles in the economic section of local newspapers, have discussions on TV and radio and partly fund trade fairs. The CCI also organises discussions with experts, government representatives and other business institutions. At the time of the survey, they could not offer any financial help, however offered advice for firm searching for external sources of finance. A loan guarantee fund was planned to start in November 1997. In the past three years the CCI could offer most of its services on a low cost basis, as they took part in a support program for private businesses and SMEs which was funded form the government and the European Union (PHARE). However, this programme ended in 1996. The CCI would have liked to continue taking part in a support programme, but the competition for such funds was very strong.

Lodz Incubator Foundation

The Incubator Foundation was founded in 1992 by the Lodz Regional Development Agency and the City Council of Lodz. The main aims of the foundation were to provide support for firms in the Lodz region with regard to finance, promotion and training. The Incubator also provided premises for small firms on a low rent basis. For this project the Incubator owned three buildings in Lodz. A commission of experts decided which firms were to be admitted to the Incubator on basis of business plans provided by applicants. Apart from office space the Incubator also provided access to secretary and book-keeping as well as technical support, e.g. phones, faxes and photocopying. Furthermore, firms within the Incubator had access to marketing and advertising services.

Lodz Agency for Regional Development

The Lodz Agency for Regional Development was established in 1992 as an initiative of the Lodz regional authorities with the support of national public institutions. Shareholders the City of Lodz Office, the Lodz Voivodship, the Agency for Industrial Development, the Town of Ozorkow Office, as well as eight banks and private enterprises, represented by the Lodz Club of Capital. The agency is a limited liability company aiming at the economic development of the region. The agency does not provide services directly of SMEs, but organises or administers projects which, among others, support small firms in the Lodz regions. Some of these projects are funded by the PHARE programmes of the European Union. Other foreign organisations they co-operate with were, for example, the Lyon Chamber of Commerce and Industry, the Foundation France Pologne, Infomest in Tries, Italy, the Friedrich Ebert Foundation in Germany, and the Edinburgh Consortium in Great Britain.