

## The Guarantee Mechanism of Small Business Lending

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### Abstract

*The state and the problems of the small business system in the Russian Federation are primarily associated with its financial conditions. Insufficient rate of small business growth relates to a variety of causes, including lack of availability of the long-term lending resources. Small business lending conditions need state-financing backing. This publication substantiates the need for growing such a form to support small business as the guarantees for getting access to supplementary financial resources.*

**Keywords:** Small business, governmental control, financial backing forms, lending, rates of interest, loan arrears.

### 1. Introduction

The small business system serves to find solution to the key problem of any state – the employment of population. The share of small business segment varies from 50% to 75% of the total employment in the EU countries and over 50% in the USA while the contribution of small business into the total employment in Russia is 17-18%. According to the official figures of Rosstat, the Federal State Statistics Service, 11,695.2 thousand persons were engaged in the small business activity in 2013 and the annual average number of employed was 67,901 thousand persons or 5.8% of the total employment. Additional tools are required for development of this system that will ensure favourable financial conditions of their functioning.

Affordability of lending resources is of most importance to the growth of the small business system. Taking significant risks of small business lending into consideration, a loan guarantee mechanism should be developed and provided to ensure lending the small business.

### 2. Theory

The matter of governmental financial backing to the small and medium-sized enterprises was covered by such authors as Walczak, D. and G.Voss [1], Cowling, M., W. Liu, A. Ledger [2], studied the positive effect of small business lending guarantees.

There are many tools of governmental financial backing provided to small business, including budget investments, governmental guarantees and subsidies. In particular, since 2008 the subsidies allocated by the federal budget to support small business have been seeking to grow. However, this level of small business growth does not match the level of other countries.

The need for further availability of loans remains actual in connexion with this. The factors that prevent expansion of small business lending are: small business size; minor part of own funds in the capital structure and absence of liquid assets; short credit history or its absence at all; high credit risks and limitations to secure the mentioned loans; mismatch of small business profitability with the interest rates on credit; instable legal system, including taxation. The authors see the solution to the problem of small business lending in perfection of the guarantee mechanism.

### 3. Results

Lending institutions unwillingness to lend the small enterprises is also explained by loan debt growth. The total loan debt amounts of small and medium-sized enterprises nationwide are listed in Table 1. Furthermore, it should be mentioned that debt arrears of both small and medium-sized enterprises increase in the total arrear volume. So, if the debt arrear was 19% in 2009, it raised to 26% by 2013.

**Table 1.** Debt arrears of small and medium-sized enterprises over a period of 2010-2014

Billions of Rubles						
Period	2010	2011	2012	Within 7 months of 2013	2013	Within 7 months of 2014
Total, including	3 227	3 843.5	4 494.2	4 938.7	5 160.6	5 389.9
Ruble lending	2 992	3 616.7	4 288.9	4 684.1	4 878.0	5 084.0
Foreign currency lending	235	226.8	205.3	254.6	282.6	305.9

Increase in arrears for the period under review suggests that the small business system fails to be liable for debts and the lending conditions are stringent. This, in turn, results in that the borrowings taken by small and medium-sized enterprises are negligible in the total corporate bank loans in Russia as compared with other countries (Table 2).

**Table 2.** Borrowings of small and medium-sized enterprises in the total corporate bank loans in 2008-2011. (according to MSP Bank studies) [17] (%)

Country	2008	2009	2010	2011
Switzerland	81.3	80.3	80.1	79
Republic of Korea	82.6	83.5	81.5	77.7
Portugal	77.7	77.4	77.3	76.8
Hungary	60.6	60	54.5	54.5
Thailand	26.6	26.9	38.4	36.8
Slovenia	48.2	47	51.8	54.3
USA	27.7	27.6	29	26.5
Russia	19.9	21.3	23.7	22.5
France	20.4	20.2	20.6	20.9
United Kingdom	18	20.8	21	20.6
Italy	17.9	18.3	19	18.3
Canada	15.6	17.9	17.5	17.5
Chile	15.2	17.5	18.2	17.4
Sweden	88.5	92.4	91.1	n/a

Notwithstanding that the borrowings of small and medium-sized enterprises have increased in the total corporate bank loans in Russia by 2.6 percentage points over 4 years, this figure does not achieve the average value of 33.8% for the above countries in 2011. This fact can be primarily explained by high lending interest rates provided to the small enterprises. The analysis of lending rates in other countries (Table 3) shows that the rates for small enterprises are higher than those granted to other market participants. However, the lending rates are much lower in the considered countries than in Russia.

**Table 3.** Lending rates for small and medium-sized business [17] %

Period	2007	2008	2009	2010	2011
Switzerland					
Mean lending rate (for loans not exceeding 1 million Swiss Francs)	n/a	n/a	2,21	2,11	2,08
Mean lending rate (for loans in excess of 1 million Swiss Francs)	n/a	n/a	0,86	0,88	0,92
United Kingdom					
Mean lending rate for small and medium-sized business	n/a	4,54	3,47	3,49	3,52
Mean lending rate for business	n/a	3,71	2,36	2,19	2,45
Czech Republic					
Mean lending rate for small and medium-sized business	5,63	5,37	4,46	4,08	3,83
Mean lending rate for business	5,1	4,8	3,72	3,47	2,86
France					
Lending rate (for loans less than 1 million Euro)	4,91	5,43	3,93	3,27	3,69
Lending rate for loans in excess of 1 million Euro	4,71	5,01	2,25	2,05	2,75
USA					
Mean lending rate for loans 100 thousand USD – 1 million USD	7,96	5,16	3,82	4,09	3,95
Mean lending rate for loans in excess of 1 million USD	6,75	4,29	2,99	3,23	3,07

Thus, the nominal interest rate for loans in excess of 3 year given to the Russian small and medium-sized enterprises as of July 2014 averages 13.27% while the actual rate including multiple bank charges and payments is 17% and higher. Regarding the corporate loans in general, it should be noted that the interest rate for loans in excess of 3 years averaged 11.9% as of July 2014. The same is true for short-term loans. Moreover, the commerce and services received most of the loans (up to 80%). The small and medium-sized production enterprises are restricted in access to bank financing as before as the security requirements are stringent to them. The situation is worsening now by the reason that the commercial banks begin with reducing their limits for small and medium-sized enterprises and tighten the requirements to these borrowers.

As practice of different countries shows, using guarantee mechanisms is the most effective tool to increase affordability of lending resources for small and medium-sized business (Table 4).

Unlike the direct budget financing of small business, the guarantee mechanisms are lower in cost; they do not prevent competition and contribute to risk assessment of both the creditors and borrowers (small enterprises) and drafting the credit agreement terms as well as strengthening ties between them. At the same time, the guarantees are a form to protect the lending agencies from high risks of small business lending.

**Table 4.** Amount of loans taken by small and medium-sized business and government guarantee secured, in 2007–2011 for the below countries [17]

Million Euro					
Country	2007	2008	2009	2010	2011
Canada	900	975	900	975	975
Chile	445.7	413.1	1252.5	2258.3	3077.9
Czech Republic	114.5	197.1	369.6	389.7	24.4
Denmark	41	29.5	37	162	259.2
France	5850	8861	11267	10883	8826
Hungary	1296.8	1483.8	2041	1604.9	1486.5
Italy	2.3	2.3	4.9	9.1	8.4
Republic of Korea	27790	30030	39410	39270	38850
The Netherlands	09	400	370	945	1040
Portugal	740	1552	4961	6285	6147
Russia	–	–	964.7	1656.6	3043
Serbia	–	10.5	2.6	2.2	–
Slovakia	115	157	143	139	167
Spain	5210	7053	5906	7236	7502
Sweden	18.8	15.7	12.8	–	–
Thailand	–	–	557324.8	–	–
Turkey	32.6	174.3	342.3	563.8	702.3
United Kingdom	242.7	208.7	890.7	690.3	425.2
USA	15.8	12.3	11.8	17.2	14.3

The existing Russian guarantee mechanism, which is implemented through the federal Guarantee Fund and the regional funds, has its own disadvantages. Despite ever-augmenting number of regional funds, one can see some drawbacks of the guarantee mechanisms. The lending agencies that wish to lose their borrowers misapply to the Guarantee Fund by sending entities unable to pay for loan guarantees. The analysis of the Russian Government Resolution No. 825 dated 14 August 2012 "Concerning the Procedure for Providing the Government Guarantees in 2012 on Credits or Bonded Loans Used by Legal Bodies for the Purposes Determined by the Russian Federation Government as Part of Measures to Enhance Economic Growth Stability if the Financial Markets Decline" brings to the conclusion that this Resolution does not clearly reflect the objectives of attraction of guaranteed loans and determine the criteria of the position of a company claimed to the guarantee.

The Russian Government is regarding different alternatives of financial backing of banks for small business lending. So far, the Government is going to complete the conceptual design of a Loan Guarantee Agency by the end of 2014. We think that this form of support will be the most effective one. This Loan Guarantee Agency being a non-bank credit-deposit organisation will be 100% owned by the Federal Government. The Agency is designed for lodging investment loan guarantees to the small and medium-sized enterprises for 2-7 years in the amount of 50-270 million Rubles if their own pledge is insufficient.

Both the national guarantee agencies system and the Loan Guarantee Agency being a core of federal guarantee fund will increase affordability of lending resources to be lodged to the small and medium-sized enterprises, specifically, to those of uncommercial sector. The goal of the Agency is to provide regional guarantee organisations of all Russian regions with counter-guarantees. The key objectives of the Agency will be:

- Reduction in credit risks of small business investment projects by means of risk sharing with the pecuniary institutions;
- Enhancement of lending conditions for small and medium-sized business;
- Increase in long-term lending capacity;
- Increased capabilities of regional guarantee agencies to provide loan guarantees to the small and medium-sized business and enhancement of their efficiency.

According to the Agency's 5-year business plan, the following financial and economic results (provided that the capitalisation is 30.0 billion Rubles) are expected:

- The total guarantee amount: 217.8 billion Rubles;
- The total guaranteed investment loans: 435.0 billion Rubles;
- The total number of guarantees granted: 6900;
- The number of small and medium-sized enterprises having guaranteed loans will be 79.5 thousand entities;
- The percentage of loans granted to the small and medium-sized enterprises and secured by the national lending agencies system will reach 4.0% of the total loan debts of small and medium-sized business.

Therefore, this mechanism of guarantee support through the Loan Guarantee Agency will be primarily targeting the small and medium-sized enterprises that realise their investment project in the regions.

#### 4. Conclusions

Generally, the small business in Russia does not yet meet the level of other developed countries. This relates chiefly to the financial disadvantages of this economic system notably it associates with severe lending conditions. The result is that the small business system raises concerns from the state due to:

- Unsettled problems of unemployment;
- Reduction of investment programmes for small and medium-sized business due to limitation of long-term lending resources;
- Failure to meet import substitution requirements.

One of the options to solve the problem of loan affordability for small business is the national guarantee backing through the Loan Guarantee Agency. The efficient risk control and appreciable social-and-economic effect of the projects is the main advantage of this support. Furthermore, the regional guarantee funds should develop and employ special lending products for the small business to facilitate the governmental contracts in order to progress the guarantee mechanism.

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