

Financing SMEs and Entrepreneurs

Why is financing SMEs so important?

How big is the SME financing gap?

What are the obstacles to SME access to financing?

How easy is it for SMEs to borrow from banks?

Where can innovative SMEs find funding?

How to bridge the SME financing gap?

For further information

For further reading

Where to contact us?

Introduction

Small and medium-sized enterprises (SMEs) are the backbone of all economies and are a key source of economic growth, dynamism and flexibility in advanced industrialised countries, as well as in emerging and developing economies. SMEs constitute the dominant form of business organisation, accounting for over 95% and up to 99% of enterprises depending on the country. They are responsible for between 60-70% net job creation in OECD countries. Small businesses are particularly important for bringing innovative products or techniques to the market.

Microsoft may be a software giant today, but it started off in typical SME fashion, as a dream developed by a young student with the help of family and friends. Only when Bill Gates and his colleagues had a saleable product were they able to take it to the marketplace and look for investment from more traditional sources.

While not every small business turns into a multinational, they all face the same issue in their early days – finding the money to enable them to start and build up the business and test their product or service.

Why is it harder for them to borrow money from banks or to find private investors than for larger firms? And why is it easier for small businesses to raise money in some countries than in others? These are important questions given the fact that small businesses, and particularly innovative SMEs, become increasingly vital to economic development and job creation as the knowledge-based economy develops.

This *Policy Brief* looks at the extent of the SME “financing gap”, and what governments can do to make it easier for them to obtain the funding they need to start, grow and prosper, and thus contribute to creating jobs and economic growth. ■

Why is financing SMEs so important?

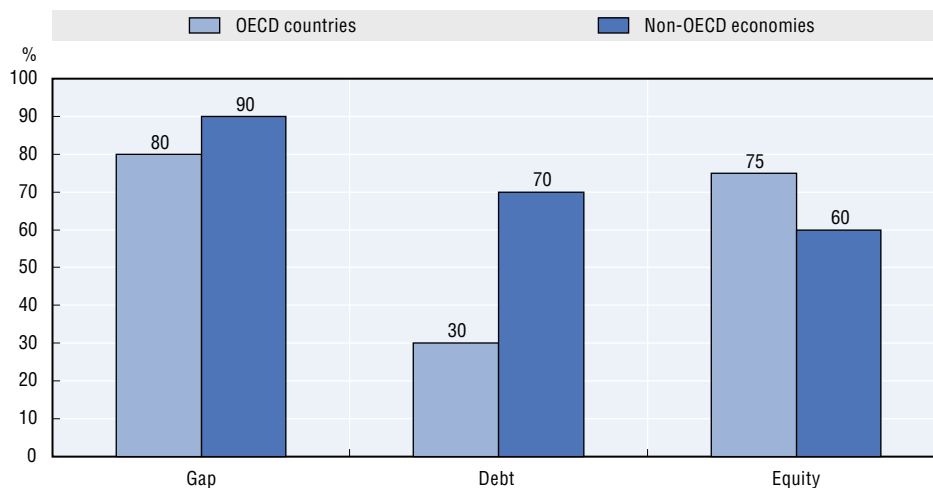
SMEs are vital for economic growth and development in both industrialised and developing countries, by playing a key role in creating new jobs.

Financing is necessary to help them set up and expand their operations, develop new products, and invest in new staff or production facilities. Many small businesses start out as an idea from one or two people, who invest their own money and probably turn to family and friends for financial help in return for a share in the business. But if they are successful, there comes a time for all developing SMEs when they need new investment to expand or innovate further. That is where they often run into problems, because they find it much harder than larger businesses to obtain financing from banks, capital markets or other suppliers of credit.

This “financing gap” is all the more important in a fast-changing knowledge-based economy because of the speed of innovation. Innovative SMEs with high growth potential, many of them in high-technology sectors, have played a pivotal role in raising productivity and maintaining competitiveness in recent years. But innovative products and services, however great their potential, need investment to flourish. If SMEs cannot find the financing they need, brilliant ideas may fall by the wayside and this represents a loss in potential growth for the economy. The “bagless” vacuum cleaner and the “wind-up” radio or flashlight which need no batteries are now common household items, but nearly failed to see the light of day because their inventors could not find financial backing to transform their ideas into production.

Already, differences are emerging between countries in terms of how easy it is for innovative SMEs to grow and develop. This sector has been very dynamic in the United States and a few other countries, but has lagged in many continental European countries and Japan, to the detriment of job creation and competitiveness. ■

Figure 1.
IS THERE A FINANCING GAP? WHERE IS THE GAP?



Note: In many cases of debt in OECD countries, this problem is limited to a sub set of SMEs, mostly start-ups and very young firms. Data is based on the responses of 20 OECD and 10 non-OECD economies.
Source: OECD SME and Entrepreneurship Financing Survey.

How big is the SME financing gap?

While the SME financing gap is more pervasive in emerging markets, business financing overall is not a problem in OECD countries (Figure 1), where banks are adopting strategies to cope with reducing the risk of lending to SMEs and where there are well-established systems for raising money through banks and capital markets.

Many countries that do not report an overall financing gap for SMEs say that they do have a financing problem when it comes to innovative SMEs, precisely because they do not fit the mould applied in traditional SME financing. Since innovative SMEs tend to be newcomers to the market, or seeking financing for a new type of product or service, and usually have negative cash flows and untried business models, they represent a higher risk to banks and cannot be assessed in the same manner as traditional SMEs or large firms.

One fundamental problem in dealing with the SME financing gap is lack of basic information about just how big such a gap may be. Often the only evidence is in the form of complaints from SMEs themselves and this is difficult to use in analysis or for comparison. Moreover, the definition of an SME varies between countries and financial institutions, some only compile figures by size of loan, not by size of the company borrowing, and some do not keep regular statistics of SME lending at all. And this is just in OECD countries – outside the OECD area, information is even scarcer. ■

What are the obstacles to SME access to financing?

The difficulties that SMEs encounter when trying to access financing can be due to an incomplete range of financial products and services, regulatory rigidities or gaps in the legal framework, lack of information on both the bank's and the SME's side. Banks may avoid providing financing to certain types of SMEs, in particular, start ups and very young firms that typically lack sufficient collateral, or firms whose activities offer the possibilities of high returns but at a substantial risk of loss.

SMEs tend by their very nature to show a far more volatile pattern of growth and earnings, with greater fluctuations, than larger companies. Their survival rate is lower than for larger companies – one analyst found that manufacturing firms with fewer than 20 employees were five times more likely to fail in a given year than larger firms. Thus, SMEs are at a particularly severe disadvantage when trying to obtain financing relative to larger and more established firms.

It can also be difficult for potential creditors or investors to distinguish the financial situation of the company from that of its owners. The entrepreneur may have re-mortgaged his or her house to acquire the start-up funds for the company, for example. If there are two cars in the driveway, can one or both be considered part of the company's assets? If the owner dies, is there someone to take over the business, or will it die with him or her?

The SME may have several stakeholders, but again unlike a large company, they are likely to be the friends and family of the SME owner. What happens if one of them decides to take his or her money elsewhere – will the other

stakeholders make good on the investment, will they look for a new investor in their own circle, or will they ask the bank for more money?

This is a very different set of financial circumstances than that faced by banks when dealing with large well-established firms, so the whole risk assessment is different. Banks and other traditional sources of credit may decide that SMEs represent a greater risk than larger companies, and respond by charging higher interest rates. This makes it more difficult for SMEs to borrow than for bigger companies, and may make it effectively impossible for many SMEs to borrow money at all because the price of credit is too high.

If entrepreneurs cannot gain access to finance through the regular system, they may not start up a business or simply go out of business, a potential loss to the economy. But the other danger is that they will abandon the formal system altogether and operate in the informal economy, sidestepping taxes and regulations, and thus not making a full contribution to economic growth and job creation. ■

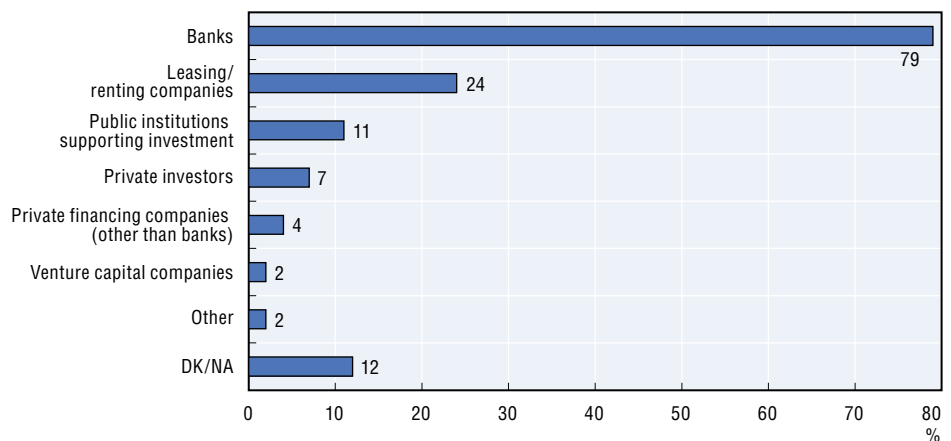
How easy is it for SMEs to borrow from banks?

In most countries, commercial banks are the main source of finance for SMEs (Figure 2), so if the SME sector is to flourish it must have access to bank credit.

The overall SME financing gap is particularly pressing in non-OECD countries, since the bulk of them report a widespread shortage of financing for all categories of SMEs. Even though SMEs account for a large share of enterprises, and represent potential employment and economic growth in emerging economies, they receive a very low share of credit. Indeed, most of them are denied any access to formal financial markets.

The characteristics of the banking system in emerging markets frequently inhibit SME lending. Many banks are state-owned, their credit may be allocated on the basis of government guarantees or in line with government targeting to develop specific sectors. Often banks are subject to ceilings on

Figure 2.
SOURCES OF FINANCING FOR EU-BASED SMEs



Source: EOS Gallup Europe (2005), "SME Access to Finance", Flash Eurobarometer 174, October, upon the request of the European Commission (Directorate-General "Enterprise and Industry").

the interest rates they can charge, which makes it difficult to price credit in a way that reflects the risk of lending to SMEs. Many banks may have ownership and other ties to industrial interests and will tend to favour affiliated companies. In a market where banks can earn acceptable returns on other lending, it will not develop the skills needed to deal with SMEs.

Market-based banking, where banks are accountable for achieving high returns to shareholders and maintaining high prudential standards, is gaining acceptance on a global level. This model creates a competitive market where there is more incentive for banks to lend to SMEs, but many emerging markets have been comparatively slow in implementing this model.

As OECD countries have competitive financial markets, SMEs do not generally have a problem in obtaining bank loans since banks perceive SME finance as an attractive line of business and are developing, or have developed, effective techniques to deal with them. They are replacing their traditional risk assessment models with new techniques to distinguish high- and low-risk SME borrowers, and to identify those likely to expand and survive. Banks are also altering the nature of their products, with an increasing proportion of their revenue coming from fees for services rather than interest on loans, which favours lending to entities such as SMEs.

Nonetheless, OECD governments are convinced that there are still enough instances of market failure in SME finance to justify focused government intervention. Countries have launched a number of programmes to use public funds to facilitate SME lending, and the available official surveys suggest that banks' efforts to develop the SME market, supported in some cases by a moderate amount of government guarantees, have resulted in a situation where a large share of SMEs have access to bank financing. ■

Where can innovative SMEs find funding?

Despite the importance of innovative SMEs, they face particular problems when attempting to access financing in most OECD countries, as they represent a higher risk than traditional SMEs or large firms. They are thus not really candidates for traditional bank loans. Moreover, banks are mindful of the fallout from the burst of the "dot.com" bubble after the steep rise of Internet-related start-ups in the late 1990s.

Instead, innovative SMEs rely on investors who will provide risk capital, generally in return for a share in the company. The risks for the investor are high, but so are the potential rewards if he or she is backing a winner.

Financing for innovative SMEs is complicated by the fact that these firms are likely to require a range of financing vehicles at different stages of their development (Figure 3). The "seed" money to start up the company generally comes from friends, professional contacts and family. The SME may also be able to tap into government funds or university grants for developing prototypes or carrying out feasibility studies. Increasingly, "business angels" are seen as a vital link in the financing chain at the early stage of business development, as they bring business experience to the table as well as their own capital.

As SMEs begin to grow, but have yet to establish the track record or size and collateral that would give them access to bank financing, they tend to turn to other types of risk capital offered by venture capitalists, who favour larger projects at later stages of the business cycle. Funds are usually obtained from institutional investors, especially pension funds, but financial intermediaries and the corporate sector are also major investors.

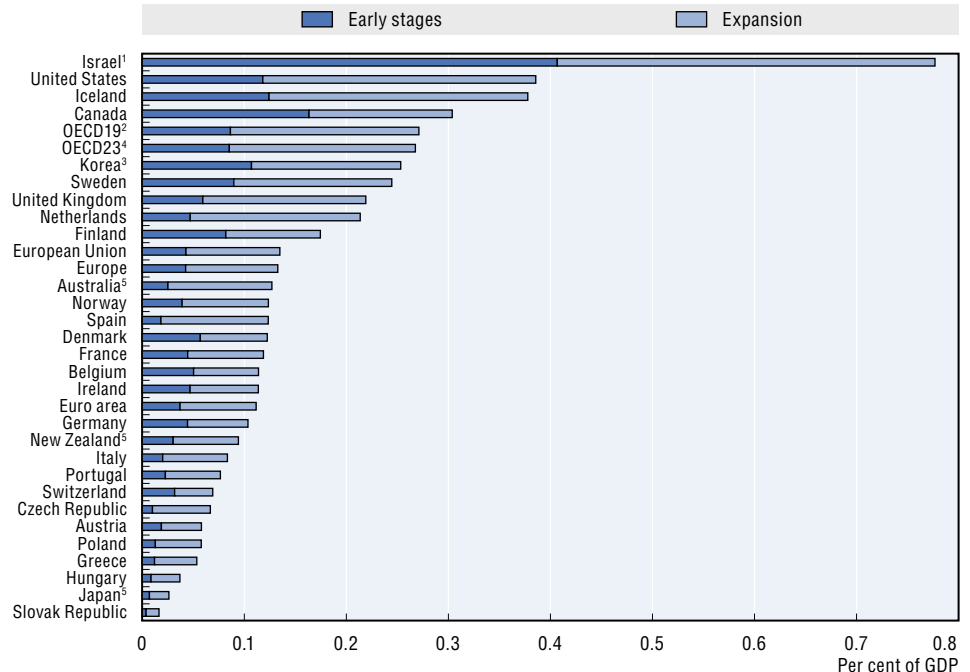
Although there are many countries (including some in the OECD) where the venture capital industry is still under-developed, the global venture capital industry is now a relatively mature industry that has succeeded in mobilising hundreds of billions of dollars from institutional investors and deploying these funds to attractive business opportunities throughout the world.

In contrast to the formal venture capital sector, the role played by early stage risk capital, although not well known, is more relevant for innovative SMEs, and thus represents an opportunity for government policy intervention. ■

How to bridge the SME financing gap?

Governments can play an important role in supporting the SME sector, particularly where there is market failure or where incomplete markets inhibit the provision of adequate financing on terms suitable for the SME's stage of development.

Figure 3.
VENTURE CAPITAL INVESTMENTS BY STAGES
In per cent of GDP, averages 2000-2003



1. 2000-2002.
2. Europe, Canada and United States.
3. 1998-2001.
4. Europe, Czech Republic, Hungary, Poland, Slovak Republic, Canada, and United States.
5. 1998-2001.

Source: OECD, based on data from EVCA (Europe); NVCA (United States); CVCA (Canada); Asian Venture Capital Journal (The 2000 Guide to Venture Capital in Asia).

Government measures to promote SMEs should be carefully focused, aimed at making markets work efficiently and at providing incentives for the private sector to assume an active role in SME finance. Where necessary, banking systems should be reformed in line with market-based principles.

Governments should also act to improve awareness among entrepreneurs of the range of financing options available to them from officials, private investors and banks. Micro-credit and micro-finance schemes play an important role in developing countries and efforts should be made to boost their effectiveness and diffusion.

Any provision of official funding should respect the principle of risk sharing, so official funds should only be committed in partnership with funds from entrepreneurs, banks, businesses or universities. Governments should also look at whether government technical support can be used generate the emergence of business angels and to make the existing business angel systems operate more efficiently.

Policy makers need to ensure that the tax system does not inadvertently place SMEs at a disadvantage. They should also review the legal, tax and regulatory framework to ensure that it encourages the development of venture capital.

At the same time, national policies should encourage diverse forms of institutional savings and institutional investors should be regulated flexibly.

The market for corporate control should be allowed to function efficiently for both domestic and foreign entities.

In order to assess the success of such actions, governments need to be able to measure the size of the SME financing gap and evaluate the impact of government actions. OECD and non-OECD governments have asked the OECD to take the lead in establishing international benchmarks to facilitate comparisons of the relative performance of markets in providing financing to SMEs and entrepreneurs and to shed light on outstanding financing gaps and issues. ■

For further information

For more information about the OECD's work on SME and entrepreneurship financing, please contact: Marie-Florence Estimé; tel.: +33 01 45 24 94 34; e-mail: marie-florence.estimate@oecd.org or Rebecca Scheel; tel.: +33 01 45 24 93 48; e-mail: rebecca.scheel@oecd.org.



For further reading

OECD (2004), **Financing SMEs in an Innovative Economy. Background Report prepared for the 2nd OECD Ministerial on SMEs, June 2004 in Istanbul, Turkey.**

OECD (2006), **The SME Financing Gap (Vol. I): Theory and Evidence.**

OECD (2006), **The SME Financing Gap (Vol. II): Proceedings of the Brasilia Conference, 27-30 March 2006.**

OECD (2006), **The OECD Brasilia Action Statement for SME and Entrepreneurship Financing.**

OECD publications can be purchased from our online bookshop:

www.oecd.org/bookshop

OECD publications and statistical databases are also available via our online library:

www.SourceOECD.org

Where to contact us?

OECD HEADQUARTERS

2, rue André-Pascal
75775 PARIS Cedex 16
Tel.: (33) 01 45 24 81 67
Fax: (33) 01 45 24 19 50
E-mail: sales@oecd.org
Internet: www.oecd.org

GERMANY

OECD Berlin Centre
Schumannstrasse 10
D-10117 BERLIN
Tel.: (49-30) 288 8353
Fax: (49-30) 288 83545
E-mail:
berlin.contact@oecd.org
Internet:
www.oecd.org/deutschland

JAPAN

OECD Tokyo Centre
Nippon Press Center Bldg
2-2-1 Uchisaiwaicho,
Chiyoda-ku
TOKYO 100-0011
Tel.: (81-3) 5532 0021
Fax: (81-3) 5532 0035
E-mail: center@oecdtokyo.org
Internet: www.oecdtokyo.org

MEXICO

OECD Mexico Centre
Av. Presidente Mazaryk 526
Colonia: Polanco
C.P. 11560 MEXICO, D.F.
Tel.: (00.52.55) 9138 6233
Fax: (00.52.55) 5280 0480
E-mail:
mexico.contact@oecd.org
Internet:
www.oecd.org/centrodemexico

UNITED STATES

OECD Washington Center
2001 L Street N.W., Suite 650
WASHINGTON DC. 20036-4922
Tel.: (1-202) 785 6323
Fax: (1-202) 785 0350
E-mail:
washington.contact@oecd.org
Internet: www.oecdwash.org
Toll free: (1-800) 456 6323

The OECD Policy Briefs are prepared by the Public Affairs Division, Public Affairs and Communications Directorate. They are published under the responsibility of the Secretary-General.