



OPPORTUNITIES AND CONSTRAINTS OF MARKET-BASED FINANCING FOR SMES

OECD REPORT TO G20 FINANCE MINISTERS AND CENTRAL BANK GOVERNORS

September 2015

Contact: Mr. Gert Wehinger, Financial Affairs Division, Directorate for Financial and Enterprise Affairs, OECD [Tel: +33 1 45 24 87 68] Email: Gert.WEHINGER@oecd.org; Ms. Iota Kaousar Nassr, Financial Affairs Division, Directorate for Financial and Enterprise Affairs, OECD [Tel: +33 1 45 24 91 16] Iota.NASSR@oecd.org or Mr. André Laboul, Deputy-Director, OECD Directorate for Financial and Enterprise Affairs [Tel: +33 1 45 24 91 27 | Andre.LABOUL@oecd.org].

This analytical report is circulated under the responsibility of the Secretary-General of the OECD. The opinions expressed and arguments employed herein do not necessarily reflect the official views of OECD member countries or of the G20.

This report was submitted to the G20 IIWG meeting in Berlin on 20-21 August 2015, and is now transmitted to the September meeting of the G20 Finance Ministers and Central Bank Governors.

This document and any map included herein are without prejudice to the status of or sovereignty over any territory, to the delimitation of international frontiers and boundaries and to the name of any territory, city or area.

© OECD 2015. Applications for permission to reproduce or translate all or part of this material should be made to: rights@oecd.org.

OPPORTUNITIES AND CONSTRAINTS OF MARKET-BASED FINANCING FOR SMES

BACKGROUND AND SUMMARY

1. **The important role of SMEs in the global economy** and their contribution to employment, value added, innovation and economic growth are well recognised. Limited capital market financing for SMEs and a heavy reliance on bank lending (particularly the case in certain economies within Europe) has made small companies vulnerable to banking system dynamics, with constrained access to lending arising in times of financial stress.
2. **Although full disintermediation of SME financing is neither achievable nor desirable, there is a need for wider use of the capital markets by SMEs**, particularly at the current juncture.¹ Given the fixed-cost nature of sourcing and monitoring particularly small and mostly local firms, capital market funding (as well as lending by non-banks) should have a complementary role alongside traditional bank lending channels. The potential role of market-based financing for SMEs has also been recognised by the G20.
3. Consistent with this objective, this short synthetic report analyses the **opportunities and constraints of capital market financing for SMEs**, drawing on recent, more comprehensive work of the OECD². This report supports more general work being conducted by the IMF and World Bank on

¹ This is also being recognised in the OECD's work on "New Approaches to SME and Entrepreneurship Financing: Broadening the Range of Instruments" that also feeds into efforts at G20 level in this area.

² See also "Unlocking SME finance through market-based debt: Securitisation, private placements and bonds", OECD *Financial Market Trends*, available at: [10.1787/fmt-2014-5js3bg1g53ln](https://doi.org/10.1787/fmt-2014-5js3bg1g53ln) and "Opportunities and Limitations of Public Equity Markets for SMEs", internal document [DAF/CMF(2015)12], revised version forthcoming in OECD *Financial Market Trends*. This synthesis report forms part of the programme of work of the OECD's Committee on Financial Markets. The report benefited from feedback provided by Committee delegates but does not necessarily reflect their official views.

identifying opportunities for market-based financing for infrastructure and SMEs³ and supports the development of G20 High-level principles on SME financing.⁴

4. The main objective of this report is to discuss the **scope for capital markets to provide a source of financing for SMEs**. The report seeks to identify feasible options for capital market financing of SMEs given the size and nature of these businesses as well as the nature and operations of capital market financing and the participants in capital markets. The report addresses the following main topics: Section I examines opportunities for SME market-based financing in the non-bank debt markets (securitisation and covered bonds, small-cap bonds, private placements⁵) as well as in the public equity markets,⁶ discussing the appropriateness of such instruments for specific segments of the SME pool. Section II looks into the constraints identified in the use of the above markets and instruments by SMEs, identifying some commonly found themes that may impede the growth of market financing for SMEs overall. Section III briefly identifies the implications of such constraints for public policy and regulation and potential measures to help alleviate such barriers without hampering the overall stability of the system.

5. **Besides being insufficiently skilled, reluctant to tap the capital markets or unaware of opportunities to tap this financing channel, SMEs have substantial structural disadvantages** in obtaining financing compared to large corporates. These structural disadvantages arise mainly from limitations inherent to the small size and heterogeneous nature of SMEs which also undermine the profitability of SME-related market transactions. Such structural limitations are mainly manifest in terms of issuance costs disproportionate to the respective deal sizes and deal economics in general, intrinsic risk assessment due to the lack of transparent and standardised information, financial sophistication, reporting capabilities, communication and visibility.

6. **Such inherent characteristics of SMEs explain the relatively small absolute number of companies that are suitable for accessing the capital markets**. Most of them are to be found at the upper end of the size spectrum when it comes to instruments such as small cap bonds and private placements, and within the group of young innovative and fast-growing SMEs when discussing publicly listed equities. This might explain the focus on bank lending and other forms of debt financing (trade finance, leasing, factoring, etc.) in policy discussions around access to finance for SMEs, besides venture and other early stage equity finance for start-ups.

7. Despite more restrictive bank lending conditions in a post-crisis deleveraging environment especially for SMEs, **bank intermediation is still recognised as essential for the financing of SMEs**. The fixed-cost nature of loan origination, infrastructure requirements related to sourcing, monitoring, credit analysis and local relationship building render banks still the dominant players in SME financing. In

³ See Communiqué of G20 Finance Ministers and Central Bank Governors, 20-21 September 2014, Cairns, available at: <https://g20.org/wp-content/uploads/2014/12/Communique%20G20%20Finance%20Ministers%20and%20Central%20Bank%20Governors%20Cairns.pdf>. See also WB-IMF-OECD Note to the G20 on "Capital market instruments to mobilize institutional investors to infrastructure and SME financing in Emerging Market Economies".

⁴ The Communiqué of G20 Finance Ministers and Central Bank Governors, 16-17 April 2015, Washington D.C., states "We ask the OECD, together with other relevant IOs, to develop voluntary high-level principles on SME financing by our September meeting." See <https://g20.org/wp-content/uploads/2015/04/April-G20-FMCSBG-Communique-Final.pdf>.

⁵ Private placements are included in the analysis as a segment of the fixed income securities market and in the interest of examining similarities with publicly traded corporate bonds.

⁶ The report does not focus on specific problems related to seed and venture capital / private equity capital inasmuch as these forms of risk financing are private in nature.

emerging markets, banks act as a bridge to informal SMEs and play a key role in connecting them with the formal economy and the markets.

8. High-quality **securitisation of SME loans** (and other liabilities such as leasing) can be therefore seen as a market-based shortcut to indirectly promote SME financing, without the complete disintermediation of banks. Transferring SME credit risk partially from originators to investors through securitisation of SME liabilities creates headroom in banks' balance sheets and allows them to further on-lend to small heterogeneous and mostly local SMEs. At the same time, banks continue to originate the bulk of small loans, leveraging on their expertise, infrastructure, local presence and relationships, while keeping some "skin in the game" to ensure robust origination practices are followed.

9. **Market financing should therefore be seen as complementary to, rather than a substitute for, banking lending.** Promotion of market-based finance for SMEs⁷ should not be seen as a way to disengage banks from SME financing, but rather as a way to complement bank lending and other financing alternatives. Indeed, **the different forms of SME financing are not necessarily exclusive:** equity financing should go "hand in hand" with debt financing and the existence of both well-functioning equity and debt markets are required for efficient and effective SME financing and for the build-up of balanced and healthy balance sheets throughout the life cycle of an SME. Strong links and interconnections exist between venture capital and other private equity looking for exits on one side, and public equity markets for SMEs on the other. Moreover, the amount of equity held by a company defines, inter alia, its debt capacity and thus the provision of debt financing.

10. **SME finance is, like SMEs themselves are, exceptionally diverse and complex,** and faces unique challenges. As such, there is no "magic bullet" to resolve the SME financing issue and it is only by pushing different ideas, avenues and instruments that the different constraints and predicaments can be tackled in developing a healthy financing environment for SMEs. **In the context of a closely interconnected SME financing environment, a holistic and coordinated effort by all market constituencies involved** (investors, intermediaries, advisors, governments, policy makers and SMEs) is required to support investment in the SME asset class and allow SMEs to fully benefit from capital market financing when and as appropriate, without posing a risk to financial stability.

11. **Recognising the need for better access of SMEs to the capital markets, there is a role for policy makers to remove any impediments to SME tapping such markets and catalyse participation of a broad spectrum of investors in them,** especially institutional long-term investors. All the same, the promotion of capital market instruments for SMEs should not be done at the expense of financial market stability. Market financing for SMEs, when used properly, can play a significant role in the recovery of the real economy by unlocking resources and capacity for further lending, broadening the SME investor base and diversifying investors' portfolios, as well as assisting in the creation of a sounder financial system through better risk sharing within the economy.

⁷ Including privately placed corporate bonds under common market standards, as in the case of the US private placement market.

I. OPPORTUNITIES IN MARKET-BASED FINANCING FOR SMES

1. Introduction

12. **SMEs play an important role in the global economy** and their contribution to employment, value added, innovation and economic growth are well recognised. In order to fulfil this role, it is important to develop capital market financing for SMEs, explore the opportunities and benefits of such financing in reducing SMEs reliance on bank lending that has (particularly the case in certain economies within Europe) made small companies vulnerable to banking system dynamics, with constrained access to lending arising in times of financial stress.

13. However, **capital market funding (as well as lending by non-banks) should have a complementary role** alongside traditional bank lending. Given the fixed-cost nature of sourcing and monitoring particularly small and mostly local firms, full disintermediation of SME financing is neither achievable nor desirable. But a wider use of the capital markets by SMEs can help them to tap the resources available from institutional, alternative and retail investors searching for diversification and yield. This is especially relevant in the current post-crisis low-growth, low return environment (OECD, 2015).

14. This section will provide a brief discussion of the **scope for capital markets to provide a source of financing for SMEs**, seeking to identify feasible options for capital market financing of SMEs given the size and nature of these businesses as well as the nature and operations of capital market financing and the participants in capital markets. First, opportunities for SME market-based financing in the non-bank debt markets will be examined, discussing securitisation and covered bonds, small-cap bonds, and private placements. On the equity side, the focus will be on public equity markets, discussing the appropriateness of such instruments for specific segments of the SME pool. Seed and venture capital/private equity capital are not covered in this report inasmuch as these forms of risk financing are private in nature. However, strong links and interconnections exist between venture capital and other private equity looking for exits on one side, and public equity markets for SMEs on the other. Moreover, the amount of equity held by a company defines, inter alia, its debt capacity and thus the provision of debt financing.

15. Thus, **the different forms of SME financing are not necessarily exclusive, but rather complementary**: equity financing should go “hand in hand” with debt financing and the existence of both well-functioning equity and debt markets are required for efficient and effective SME financing and for the build-up of balanced and healthy balance sheets throughout the life cycle of an SME. The “life cycle” paradigm for SMEs and larger corporates is widely accepted by academics and market participants (Meyers, 1998, Pratt and Morris, 1987, Carey et al., 1993, Berger and Udell, 2003). According to this paradigm, different sources of debt or equity finance become important at different stages of the firm’s growth, with the various forms of debt financing complementing the different forms of equity financing. For example, the capacity to lever the capital structure of a firm by issuing debt often depends on having sufficient equity in the capital structure. Accordingly and as this short report concludes, there is no single solution or “magic bullet” to resolve the SME financing problems. Yet the diversity and complexity of SMEs also provide for a wide range of opportunities for consideration to be given to market-based finance.

2. SME Securitisation

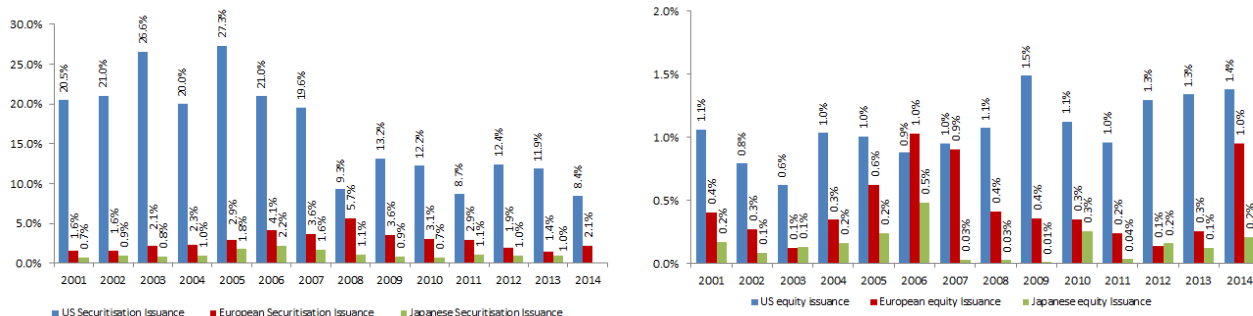
16. **SME-related securitisations** are produced through the pooling of a number of SME assets by a financial intermediary, typically the originator of the loans. SME securitisation allows banks to transfer credit risk partially to the market while achieving capital relief. As a result, capital is freed up and can potentially generate further funding capacity and on-lending to SMEs and other parts of the real economy.

It can therefore be described as an **indirect financing instrument for SMEs**. Through various forms of credit enhancement supplied by internal (e.g., overcollateralisation) or external (e.g., guarantees) sources in order to achieve the desirable credit quality, non-investment grade pools of SME loans or parts of SME loan portfolios can be enhanced and transformed into investment grade instruments.

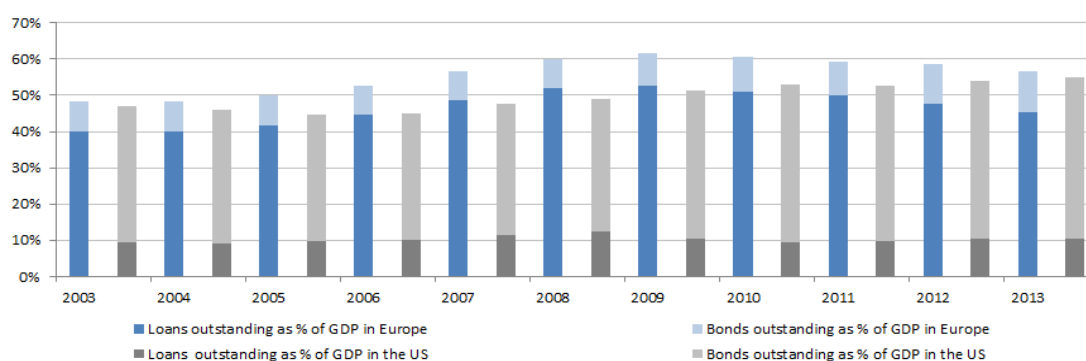
17. **Securitisation provides an efficient way to alleviate credit constraints and improve the diversity of credit supply to SMEs in an indirect way and with numerous benefits.** Investors can diversify their investment portfolios and get exposure to the SME asset class, while still achieving potentially attractive yields according to their risk/return profile. The ability to tailor securitisation transactions to meet different investor needs, coupled with the numerous credit enhancement possibilities, allow the originators to tap into a wider and more diversified investor base than through senior unsecured debt. As the diversity of credit supply to SMEs is improved in a well-functioning and efficient securitisation market, **SMEs can become an asset class that is “investable”** and reached by institutional investors or other types of “patient” capital. Securitisation indirectly benefits SME loan origination by encouraging best practices for originators. SME lending is also somewhat decoupled from banking sector cycles, with potential beneficial countercyclical effects for the macro economy. Fostering SME securitisation also has the potential to address fragmentation in SME credit markets, an issue especially relevant for Europe.

Figure 1. Securitisation and equity issuance, bonds and loans outstanding in major economies

A. Securitisation issuance (Annual, in per cent of GDP) **B. Public equity offerings (Annual, in per cent of GDP)**



C. Bonds and loans outstanding (Annual, in % of GDP)



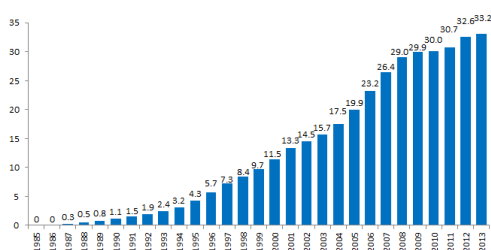
Source: OECD (2015).

18. In the aftermath of the financial crisis, resurgence of securitisation issuance has been swift in the US, with the market rebounding in 2013 to almost two-thirds of the pre-crisis levels but falling back close

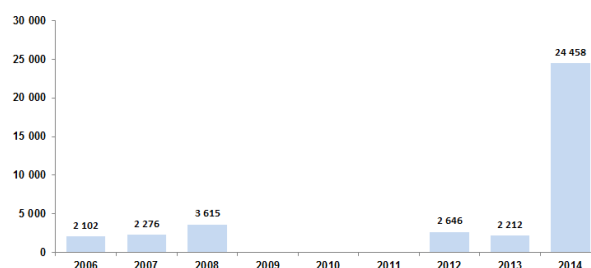
to 2011 levels in 2014 (Figure 1). Unlike the US, the securitisation market in Europe nearly shut post crisis and did not enjoy a similar recovery, with EUR216bn of issuance in 2014, just one-fourth of the pre-crisis peak. SME securitisation has been relatively underdeveloped compared to other securitisation classes and to a large extent driven by the provision of official sector guarantees (both US and Europe) or linked to unconventional monetary policies implemented in the past years (Europe) (Figure 2). The Chinese securitisation market is a recent, though steadily developing market, marked by restrictions in issuance levels (prescribed by quota), limited non-bank participation, and the absence of a dedicated legal framework, but with an enormous growth potential.⁸ The Chinese government is lately placing increasing emphasis on securitisation as a means to free up assets on banks' balance sheets and the regulatory easing around issuance is expected to spur rapid growth in the ABS market over the medium term.

Figure 2. SME Securitisation market in different regions

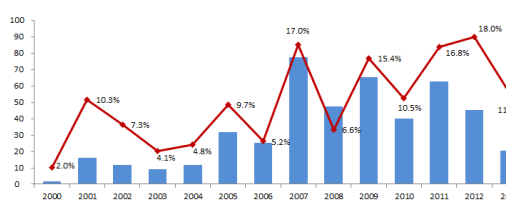
A. Small Business Loan Administration ABS outstanding (Annual, 1985-2013, in USD bn)



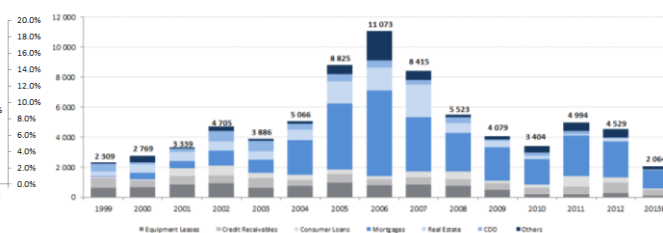
B. Issuance of asset-backed and mortgage-backed securities in China (Annual, 2006-14, in USD m)



C. European SME securitisation issuance (Annually, 2000-14, in EUR billion (l.h.s.) and as a % of total issuance (r.h.s.))



D. Japanese securitisation issuance (Annual, 1999-2013E, in billion YEN)



Source: AFME, Bloomberg, SIFMA, and Thomson Reuters, ,

3. SME Covered Bonds

19. Similarly to securitisation, **SME covered bonds are asset-backed debt instruments secured by a priority claim on SME high-quality assets, but remain on the lender's balance sheet.** Covered

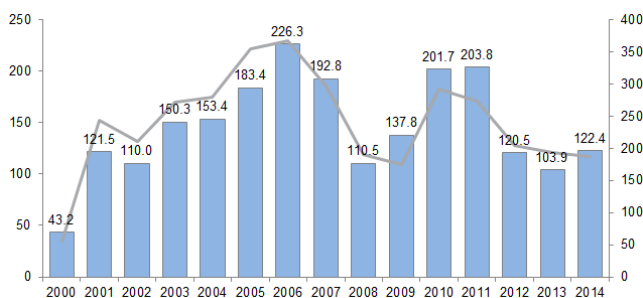
⁸ Total securitisation issuance since the introduction of the asset class accounts for only 0.1% of total banking assets of about RMB 172 trillion (as of December 2014, according to data from Thomson Reuters Datastream). The latest quota of RMB 500 billion (as of May 2015) is about 0.3% of total banking assets, a startling difference against the equivalent ratio in the United States, where outstanding ABS securitisation roughly exceeds 60% (as of end of 2014).

bonds offer an alternative cost-effective form of wholesale funding which remains resilient even in times of crisis, as well as investor diversification. They have the potential to enable the channelling of funds to the real economy in an efficient and simple way, and can **also be described as an indirect SME financing instrument**. Given that covered bonds stay on issuing bank's balance sheet and do not provide the possibility of risk transfer and regulatory relief offered by securitisation, they involve asset encumbrance considerations which can restrict their use in deleveraging environments. Covered bonds are either governed by specific legislation (statutory framework) or on general contractual rules and structured programmes in markets where a relevant legislative framework is absent.

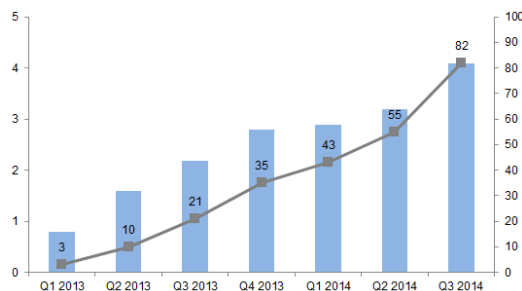
20. Compared to securitisation, covered bonds have emerged from the crisis relatively unscathed and remain one of the key components of capital markets, providing cost-effective and diversified funding to issuers and a safer alternative to senior unsecured securities for investors (Figure 3a). The attractiveness of the instrument lies to a certain extent in its key “safety” features (**dual recourse** against default). In Europe, a long history of the instrument in the market combined with a favourable eligibility treatment in the context of ECB's (and other central banks') operations has further encouraged issuance levels. Nevertheless, **asset encumbrance** concerns restrict their use in the current deleveraging environment, and limit their role as full substitute for securitisation.

Figure 3. Selected European Covered Bond Issuance, mini-bond issuance in Italy

A. Selected European covered bond issuance (annual, 2000-14, in EUR bn (l.h.s.) and number of issues (r.h.s.))



B. Mini-bond issuance in Italy (quarterly, in EUR m (r.h.s.) and in number of transactions (l.h.s.))



Source: Thomson Reuters, Bloomberg.

4. Small cap bonds / mini-bonds

21. Contrary to securitisation and covered bonds, which are indirect SME financing tools, **bonds are directly issued by the company and placed with investors**. SMEs are to a large extent **ill-equipped** for direct debt issuance on corporate bond markets, not least given the widespread lack of credit ratings among SMEs. The costs SMEs have to bear for reporting requirements associated with bond issuance coupled with the cost of obtaining a credit rating are disproportionately high when compared to the overall size of the average deal. Thus, this **market is suited mostly to the upper segment of the SME size spectrum and beyond, essentially medium-sized and larger companies**. Costs borne by investors for the analysis and monitoring of the creditworthiness of SMEs are also high as a proportion of the transaction size, limiting the active investor base for such issuances.

22. **A number of specialised retail bond markets for smaller companies have been established in recent years:** London Stock Exchange's Order Book for Retail Bonds, Émissions Obligataires par Offre au Public on Alternext, the New Alternative Fixed Income Market MARF in Spain and the Entry Standard platform at Deutsche Börse are just a few examples of such markets in Europe. Other innovative approaches, such as intermediary vehicles that pool small cap bonds in funds or mini-bonds trading on specialised platforms (ExtraMOT Pro platform in Italy) offer smaller SMEs the opportunity to directly tap

the debt markets (Figure 3b). The success that **mini-bonds** have experienced in Italy could be partly attributed to the exemption from the requirement of prospectus issuance and the waiving of the respective cost for small companies.

23. Despite simpler processes, more flexible requirements and less costly issuance possibilities offered by specialised platforms, bond issuance is still far from widespread for the vast majority of SMEs. High default rates experienced by investors in some European markets have put to question the quality of such issuances and the standards applied, as well as the safety of their marketing to all retail investors. Bond issuance for SMEs therefore **remains almost exclusively reserved to larger SMEs**, something that is not expected to materially change particularly in economies where the majority of SMEs are micro-enterprises.

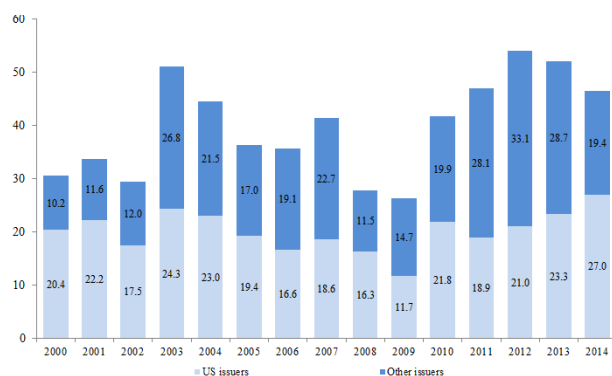
5. Private Placements

24. **Private placements offer an alternative to public corporate bond issuance, providing a source of funding without the need for a formal credit rating or reporting requirements** common for other capital market debt products. Privately placed bonds are negotiated and placed with a small number of mostly institutional investors in countries where a framework for such instruments exists (e.g. USPP market, Schuldschein market in Germany, Euro PP in France). With no minimum size limit, privately placed bonds can cater to the needs of issuers of small tickets – with issuances in the single digit USD million being reportedly delivered to very small companies in the United States. In practice, however, the average small privately placed bond is roughly within a EUR 20-30 million range according to market observers, therefore still **servicing the upper end of the SME size spectrum**.

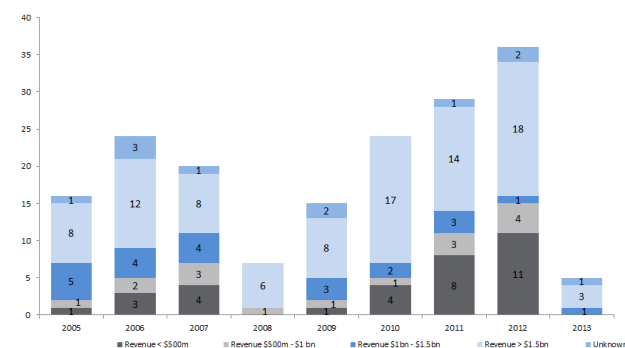
25. Growth of the existing private placement markets, as well as cross-border issuance (mostly tapping the US market) indicates that there is a **growing supply and demand, especially from institutional investors, for this instrument** (Figure 4). Initiatives promoting the establishment of regional **standardised frameworks** for private placement issuances, such as the one led by the industry in Europe (ICMA, 2015), are expected to further boost the depth and breadth of those markets, investor and issuer interest for this instrument. Nevertheless, it is expected that such markets will continue to serve medium and larger-sized SMEs, not least due to issuance requirements and deal economics.

Figure 4. US Private Placements by US and non-US issuers

A. US Private Placements issuance by US and non-US issuers (Annual, 2000-14, in USD bn)



B. European companies tapping the US PP market (Number of deals annually, by revenue size, 2005-13)



Source: Thomson Reuters, Standard and Poors.

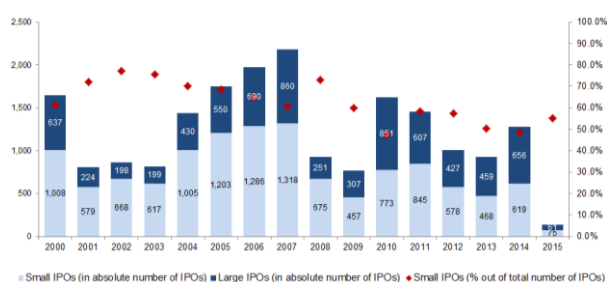
6. Public equity listings

26. **Public equity markets provide appropriate financing for high-growth, innovative SMEs**, where unpredictable cash flows and lack of track record renders bank lending unsuitable, if at all possible. There are benefits of public equity offerings for SMEs that extend beyond initial access to capital (IPO), to longer-term repeat access to financing (secondary/follow-on raisings), as well as to benefits related to increased creditworthiness, transparency and visibility by the association to a dedicated ecosystem.

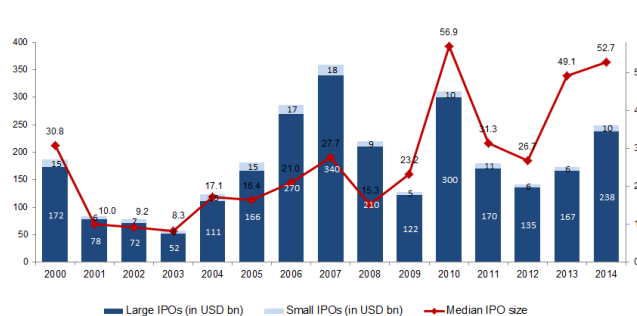
27. A number of **growth segments in regulated markets, multilateral trading facilities and other specialised SME equity platforms** targeting smaller issuers have been established in different parts of the world as an alternative, and precursor, to main exchange listings. Growth markets offer more flexible listing criteria, eased disclosure requirements and comparatively low admission costs so as to cater to SMEs' inherent characteristics. While post-crisis activity in terms of IPOs on these specialised exchanges has slowed, in some cases more than on main exchanges, these segments remain an interesting listing alternative for small companies (Figure 5).

Figure 5. Small public equity offerings

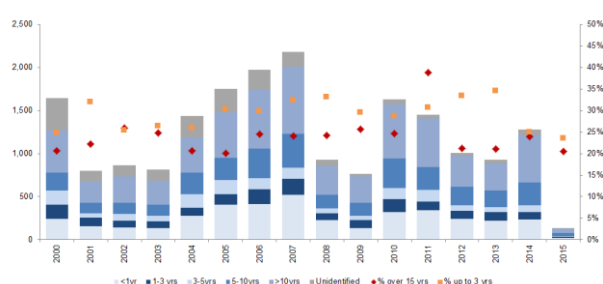
A. Global Small IPO issuance (Absolute number of IPOs (l.h.s.) and number of small IPOs in % of total (r.h.s.), global, 2000–2015q1)



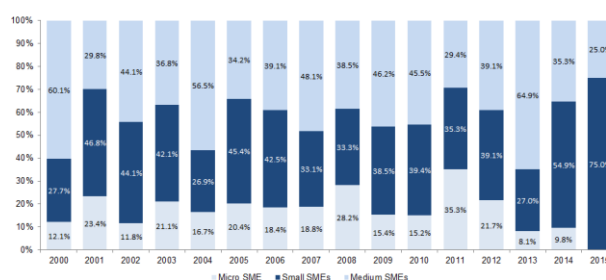
B. Global Small IPO issuance proceeds (in USD bn (l.h.s.) and median IPO size in USD bn (r.h.s.), global, 2000-2015q1)



C. Breakdown of global IPOs by age of company at the time of listing (In number of IPOs (l.h.s.) and in % of total IPOs (r.h.s.))



D. Split of European SME IPOs by number of employees (In per cent of total SME IPO sample)



Source: Opportunities and limitations of public equity markets for SMEs [DAF/CMF(2015)12].

Notes: Global IPOs as defined in Endnote 1. Excluding real estate investment trusts (REITs) and blank check companies or special purpose acquisition vehicles (SPACs). Age from year of founding to year of listing, rounded to full years for calculation purposes. Chart D based on the analysis of a sample of 1,102 IPOs identified to have been performed by European SMEs, as defined by their number of employees according to the EU definition (Employee criterion defined as follows: <10 employees corresponding to a Micro SME, <50 to a Small and <250 to a Medium-sized SME).

28. Public equity markets can be perceived as **natural platforms for equity financing of those SMEs that have important growth prospects**, with a specific focus on the firms' risk and performance

characteristics rather than on their size. The pool of later-stage, fast-growing small businesses and their respective needs are different from those of the broad SME pool. Public equity issuance can fill the SME funding gap for “growthness”, i.e. the financing gap for risk capital for the SME segment of fast-growing companies with innovative characteristics.

29. **Public equity markets are to a large extent tapped by *fast-growing, young* SMEs.** Indeed, in the period 2000-15, the percentage of companies choosing an IPO path less than 3 years since foundation of the firm has been consistently higher than the percentage of older companies of 15 years or more of existence (Figure 5c). More widespread issuance of equity by more "mainstream" SMEs would be beneficial for the real economy as more stock market financing has been shown to boost the levels of economic growth (Cournède *et al.*, 2015).

II. CONSTRAINTS IN CAPITAL MARKET FINANCING FOR SMES

30. When looking into the impediments to the growth of the abovementioned capital market financing instruments for SMEs (Figure 6), a few **recurring themes** are observed across instruments. Addressing those commonly held obstacles will unlock the potential of those markets for targeted SMEs. Resolution of other constraints on a case-by-case basis can unleash potential for specific segments of the SME population which are most appropriate to tap the relevant markets.

1. *Data paucity and lack of infrastructure for information sharing and analysis*

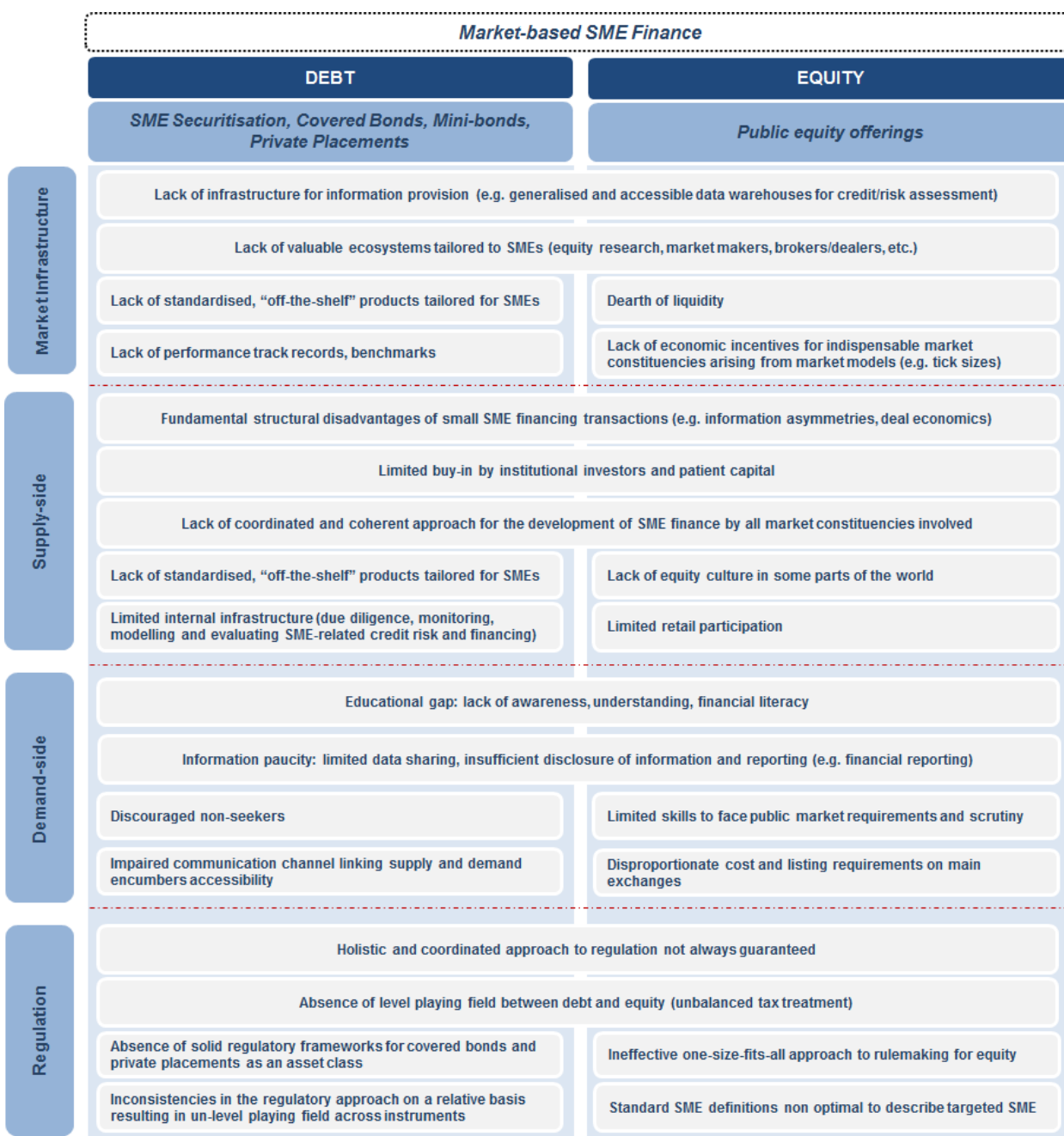
31. **Lack of availability of high-quality credit information of the right form (comparability) and at the right time (timeliness) is arguably the most significant impediment to market-based SME financing,** particularly at the debt side of the spectrum. Information around the creditworthiness of the finance seeker is particularly important in SME transactions, given the high heterogeneity of the SME sector. At the same time, SME entrepreneurs are often less prone, willing or able to share risk sensitive information. Sourcing and monitoring SME financing overall entails a significant fixed cost for market participants.

32. **Lack of data on creditworthiness, financial performance and financing track record of SMEs contribute to information asymmetries** which inhibit the development of SME capital market financing instruments. The importance of data and information for credit markets has been advocated by several academics (Stiglitz *et al.*, 1981; Miller, 2003) arguing that the asymmetric information between provider and receiver of financing is a fundamental characteristic of credit markets, leading to adverse selection and moral hazard on behalf of the borrower. The same principles apply to market-based financing and the corresponding instruments more generally, and it can be argued that better availability and sharing of information can positively influence the behaviour of both seeker and receiver of finance, countering adverse selection and moral hazard risks.

33. **The lack of high-quality, granular loan-level data on SMEs hinders the development of more rigorous fundamental analysis of financing instruments such as SME securitisations.** Loan-by-loan information allows for the statistical analysis of securitisation issuances by investors and the analysis of parameters that are meaningful only in relation to each specific loan (interest rates, maturities, collateral pledged). The main reasons for the absence of such loan-level reporting and data provision is the cost of

the supporting infrastructure and the cost of maintaining such databases, as well as the cost of regular reporting by the issuers themselves and the economic disincentives for lenders in sharing relevant credit data.¹ It should be noted, however, that SME lenders may not be willing to share information due to commercial reasons, thus so far most projects with the objective to combine and make more widely available information from different commercial banks have failed and therefore the mandatory – to some extent – provision of data could be considered, as argued below. At the same time, central credit registers cannot be expected to cover the lack of data around start-up and early stage companies which have not yet received bank debt financing.

Figure 6. Constraints of market-based instruments for SME finance



Source: Opportunities and limitations of market-based finance for SMEs [DAF/CMF(2015)13].

34. **Absence of transparency around the creditworthiness of SME issuers is at the same time acting as a barrier to entry for new and alternative providers of SME financing.** Sharing of SME data information and historical performance of past transactions amongst providers of SME financing will not only allow for better credit evaluation of SME-related instruments, but will also level the playing field across institutions, lowering barriers to entry into the SME financing space, thus improving the availability of credit to SMEs (BoE, 2014).

35. **Central credit registers and DataWarehouses, owned and operated by central banks or financial supervisors,** address this issue in a number of regions. In Europe, such an initiative was launched by the European Central Bank (ECB) in 2013 through the European DataWarehouse⁹ (ED), comprising loan level reporting for underlying loans of ABS issued in Europe. ED is the first ABS warehouse ever created that is owned by its market users, and it is being supported and endorsed by the ECB and members of the Eurosystem. The Eurosystem and other central banks, including the Bank of England (BoE), are fully engaged in obtaining greater structural and collateral transparency and both require loan level data to be made available in order for asset-backed bonds to be eligible as collateral at each bank's liquidity operations.

36. Besides the establishment of such data platforms, **mandatory reporting and sharing of credit information** could be a way to enhance completeness and availability of SME credit information, perhaps on an **anonymised basis** for some of these data (BoE, 2014a) for reasons related to the protection of confidentiality. Credit reporting systems aiming at reducing information asymmetries enhance competition and reduce default rates, ultimately resulting in lower cost of funding and easier access to credit (IFC, 2012).¹⁰ The SME asset class would **benefit from the creation of additional specialised credit registers and collateral registries providing data on SME performance** while being in line with national confidentiality and privacy laws.

37. **Fully transparent loan-level data and information on SME performance, freely accessible to all qualified users like institutional investors, could be regarded as a public good.** Thus, building and operating SME DataWarehouses may require public support. However, although public support is relevant and important, the burden of the cost should not necessarily lie entirely with the public sector and providers of financing should not be dis-incentivised from collecting and disseminating credit information, as appropriate.

38. **The availability of data per se is of little use if it is not being understood and used by the relevant professionals in order to make informed investment decisions.** Better availability and higher quality of information is a prerequisite for investors to be able to run accurate models of default and recovery rates (ECB and BoE, 2014b). Nevertheless, the **absence of internal infrastructure required for the assessment of SME-related risk** by some institutional investors new to this asset class is another stumbling block to the wider investment in SMEs by such players. In addition, lack of standardised reporting by SMEs impedes comparability and does not allow investors to perform comprehensive and well-informed analysis on the underlying exposures.

39. **Accessibility of high-quality data on SME performance and creditworthiness can be instrumental in detaching investment decisions from a pure external ratings-driven decision making,** addressing the issue of excessive reliance on external credit ratings without a proper understanding of the transaction involved. When it comes to SME securitisation in particular, the inability of investors to

⁹ www.eurodw.eu

¹⁰ For a more elaborated analysis of credit information sharing, see OECD's discussion paper on Credit Information Sharing (OECD, 2010).

accurately size the credit risk by performing their own fundamental analysis has meant that many such instruments tend to overprice risk (“trade to worst”).

40. Abundance of data on SME credit performance would aid the **development of standardised metrics of credit performance, i.e. credit rating/scoring assigned by credit rating agencies or credit bureaus, at a potentially lower cost.** As mentioned, the cost required for the attribution of credit ratings to small corporate bond issuances is one of the main roadblocks for smaller SMEs wishing to tap the main corporate bond markets. In this context it is noteworthy that a large part of the success of the US private placement market is attributed to the role of the National Association of Insurance Commissioners (NAIC) assigning credit scoring to PP issuances¹¹. The establishment of similar mechanisms at market-wide level in Europe and in the largest emerging market economies would be a way to create the level of transparency and uniformity necessary for investors to engage in credit markets.

41. **Public and private initiatives for the establishment of credit registers with scoring systems attached to them** existing in a number of countries should be followed as best practices. The Small Business Administration in the US is using the national credit rating system of the Fair Isaac Corporation (FICO) and its Small Business Scoring Service product (SBSS) to expedite credit decisions for all 7(a) loans up to USD 350,000. The FIBEN system sponsored by Banque de France, collecting information on a loan-by-loan basis (whenever a bank has an aggregate exposure above a EUR 25 000 threshold for the corporate) and assigning ratings to all corporates (above a EUR 750 000 annual turnover threshold), is another best practice example. Similarly, Kredi Kayit Bürosu, the national credit registry in Turkey, is also offering credit scoring services.

42. Limitations in the accessibility of such credit assessments only to banks or other regulated entities could be seen as a constraint in the above effort. **Mimicking such initiatives and broadening their accessibility to potential investors** (in an anonymised way) would be beneficial to SME financing allowing them to make their own judgements about risks related to SMEs.

2. Absence of standardisation: product frameworks, processes, documentation, reporting

43. **Promotion of standardisation at various different levels** could play an important role in promoting market-based SME financing. Such standardisation efforts could range from information provision and sharing, reporting and accounting by SMEs to standardisation of instruments as well as market standards and frameworks.

44. **Standardisation of information** around the financial performance, creditworthiness and performance track record of SMEs seeking financing provides greater comparability and allows investors to perform comprehensive and well-informed analysis on their exposures. Standardised loan templates for the provision of details around SME structured products by issuers have already been launched in 2013 by the European Central Bank. Data that is available and presented in a more harmonised format is more user-friendly, encouraging the actual use and proper understanding of the data by investors while also allowing for easier modelling and credit assessment throughout the life of the investment. Lack of standardised

¹¹ As well as providing investors with regulatory guidance on respective capital weightings. The existence of a credit scoring mechanism is recognised as an important enabling factor for the thriving US PP market, views differ as to whether such initiatives should be led by the public or the private sector. In practice, when the NAIC’s Securities Valuations Office (SVO) provides credit quality assessment for a PP issuance, the first insurance company actually buying the PP pays for this service and all subsequent purchases by other insurance companies benefit from the already attributed credit scoring. The cost of such analysis is modest (under USD 5 000), the SVO ratings are recognised by the regulator and the system is designed to align incentives with regard to information.

reporting by SMEs impedes investors in their risk analysis and portfolio selection process. The cost and corresponding benefits of introducing accounting principles tailored to SMEs deserves to be further explored. Standardised prospectuses and proportional disclosure requirements for SME listed equities can contribute to lowering the costs associated with the listing process and with the ongoing requirements once public (both of which mentioned as prominent reasons for the inability of small issuers to tap the equity markets).

45. Standardisation plays an important role when it comes to the **design of the instrument** itself as well as the transaction process. **Greater standardisation of SME loans** would make it easier to securitise them and would potentially assist the establishment of a wider market, along the lines of the RMBS market based on underlying standardised mortgage loans. **The development of “off-the-shelf” versions** of non-bank debt financing instruments for SMEs could be further supported with a view to lowering the cost of such instruments and increase their efficiency and accessibility by SMEs and retail investors.

46. Lack of standardisation has been, for example, one of the **key barriers to the development of the nascent private placement (PP) market in Europe**. Lack of standardised documentation increases the issuing cost (advisory, legal fees and other), as individual agreements need to be drafted for each transaction. Standardisation of documentation is indeed considered to be one of the enabling factors in the US PP market. US PPs benefit from standard loan documentation (Model Note Purchase Agreement) and covenants, rendering them user-friendly “off-the-shelf” products which are more straightforward and attractive to both investors and issuers. To that end, the Pan-European Corporate Private Placement industry initiative led by the International Capital Market Association intends to provide a non-binding framework of best practices, enhancing the standardisation of the Euro PP market¹².

47. **The absence of solid frameworks for the SME covered bond asset class** at national or broader international levels is impeding their growth and could be further encouraged. There is no one single definition of a covered bond across markets. Although the principles are the same for all covered bonds, in practice the different legislative frameworks in different jurisdictions provide for different variations of covered bond instruments.¹³ Not surprisingly, investors in covered bonds exhibit significant home bias (ECBC, 2013). Different national legislative frameworks (including recovery and resolution procedures) and the difficulty in obtaining information about the foreign markets and their different characteristics are among the main reasons that limit investor participation in international covered bond markets. Such solid common frameworks for covered bonds would need to nonetheless maintain the high standards set in some of the jurisdictions (e.g. Germany) in order to ensure that the historically successful performance of the instrument in these markets is not disrupted. The different characteristics of underlying collateral would need to be appropriately depicted in the individual types of covered bonds covered under such frameworks.

48. **Concrete actions to make securitisation transactions more standardised are already being taken** by public authorities and the private sector, for instance in terms of standardisation of reporting templates but also in terms of differentiation of “high-quality” securitisation products. A number of official sector and industry-led initiatives have been proposed in recent months with a view to identify simple, transparent and comparable securitisation structures and foster the development of such structures, including: the industry-led Prime Collateralised Securities (PCS) initiative, the differentiation introduced in European regulation based on the concept of *high-quality securitisation* for simple and transparent securitisations, the proposal by the Bank of England, the European Central Bank and the European

¹² For more detail, see the Pan-European Corporate Private Placement Market Guide issued on February 2015 (ICMA, 2015).

¹³ Some of the main existing frameworks include German and Austrian Pfandbriefe, French Obligations Foncières, Spanish Cédulas Hipotecarias, Danish Realobligationer, Swedish Sakerställda Obligationer and the Lettres de Gages in Luxembourg.

Banking Authority on *simple standard and transparent securitisation transactions* as well as the setting out of criteria by the Basel Committee on Banking Supervision (BCBS) and the International Organisation of Securities Commissions (IOSCO). The idea is to formulate a set of generic standards and rules that define simple structures and well-identified and transparent underlying asset pools with better predictable performance. Securitisations that meet this new set of rules will likely benefit from more favourable regulatory treatment, including reduced risk weightings for securitisation assets held in the banking book, such as SME-related credit. **Such standardised systems can create the conditions to encourage new financing instruments** and promote the availability of high quality information in relation to them.

49. **Despite the benefits offered by increased standardisation, full standardisation in the context of the SME universe has limitations and may not always be desirable**, due to the inherently diverse nature of SMEs. The capacity of securitisation, for example, to allow for various degrees of credit enhancements through different sizes of tranches and different forms of credit enhancing, is consistent with the diverse characteristics of SMEs. At the same time, aggregating large pools of SME loans allows for the smoothing out of idiosyncrasies. The high heterogeneity of SME pools is an important source of attractiveness to private investors, with some investors arguing that, despite a fairly high implied probability of default of individual SME loans, the relative stability of SME portfolios renders them attractive from the standpoint of a private investor.

50. **SME definitions and corporate bankruptcy regimes** are other areas where arguably there is room for more standardisation. Inconsistent definitions of SMEs and consequently of SME-specific financing instruments hamper the ability of the market to properly quantify the opportunity and the market. Similarly, data available around SME finance are often based on inconsistent definitions. Differences in insolvency laws may pose obstacles for cross-border investment in SME markets that hinder stronger growth of such markets and their instruments on a national and cross-border level. Reducing divergences in national insolvency frameworks could contribute to the emergence of more cross-border SME financing by reducing uncertainty for investors and issuers together.

3. Lack of ecosystems catering for SMEs' capital market needs

51. **The lack of SME-specialised ecosystems that can support small-sized transactions and accompany SMEs at the issuance/listing and in the aftermarket** is an important constraint for SME market-based finance. Public equity offerings, for example, need to be supported by a healthy ecosystem dedicated to sustain capacity to take SMEs public and support them in secondary markets. Such ecosystems consist of investment banks, SME-specialised banks, research analysts, sales, brokers, market makers, and other third party advisors focused on SMEs (Figure 7). Legal and financial advisors, accountants and other professionals providing ancillary services specifically targeted to SMEs can benefit issuing companies, investors and the overall market by enhancing transparency and confidence. Such ecosystems could be developed at the local level, in case the small local growth market model is chosen, or at a more centralised level, in case the model of proportionate participation of SMEs in some main exchanges is favoured.

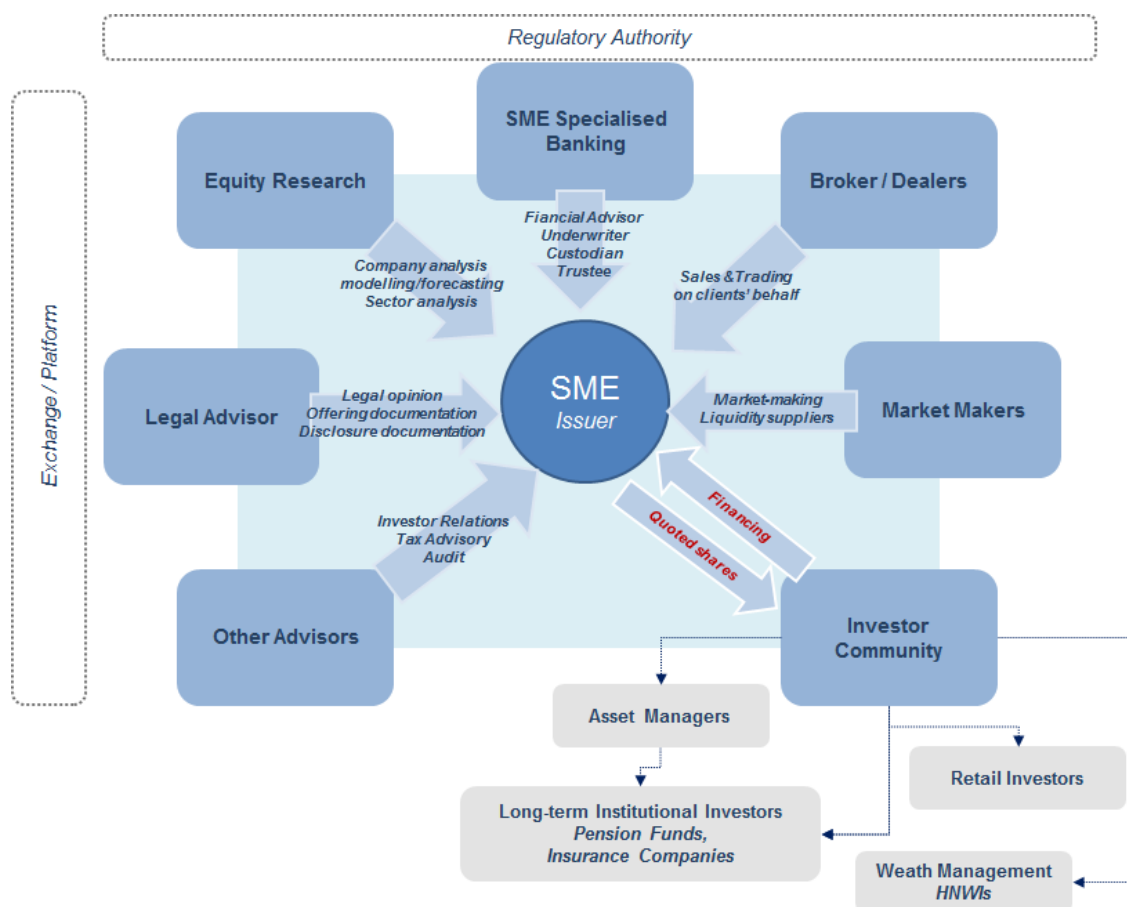
52. **The absence of a capital market-related ecosystem that can cater to SMEs' specific needs impedes the functioning and deepening of equity markets and reduces their willingness to list altogether.** Currently the ecosystem for SMEs is not wide-ranging enough, to a large extent due to the lack of profitability, i.e. an economic rationale of SME-related services by brokers and advisors in general. A larger number of participants in such an ecosystem would create a greater capacity to take SMEs public and support them in the aftermarket. Consequently, more IPOs could get executed when the "IPO window" is open, which in turn would create a willingness on the part of investors to invest in small quoted

companies and lead other private companies or VC/PE investors to consider the IPO as a viable exit strategy.

53. **Market-makers in particular act as catalysts to the provision of liquidity in secondary markets, but are somewhat challenged by regulatory reforms.** The existence of committed market-makers providing buy and sell quotes at any given time is critical to professional investors' participation in small equity markets. Without liquidity, professional investors tend to shift their assets away from SMEs into larger capitalisation stocks.

54. **The declining provision of equity research on small and mid-sized companies** (but also across the board) reduces their visibility and attractiveness among professional investors. Equity research plays a key role in equity markets, assisting investors in making informed investment choices, providing absolute and relevant evaluation of the attractiveness of an individual stock/industry/market and of the expected operating performance of the underlying company. Equity research is of particular importance in the case of small high-growth companies where information is scarce and harder to assess. It is argued by market participants that equity research assists capital formation by potentially lowering the cost of capital for growth companies, as they balance short-term losses and risks with long-term company valuation estimates in their evaluation exercises. Good equity research coverage improves public awareness of listed companies and of the broader markets and promotes them to institutional and other investors.

Figure 7. A valuable ecosystem for SME equity offerings



Source: OECD (Opportunities and limitations of public equity markets for SMEs [DAF/CMF(2015)12]).

55. Equity research coverage of small and mid-sized equities is constrained because of cost considerations, the inherent characteristics of small companies, and regulatory changes in some markets. The relative size of small company IPOs and secondary trades renders equity research provision for small companies economically challenging, if not unviable. The “transparency barrier” resulting from the reluctance to share sensitive information by even the most successful and best managed SMEs in order to protect their strategic position is another impediment to their research coverage (Altenburg, 2013).

56. Policy makers have a role in facilitating the infrastructure element of the ecosystem around SME public equity markets and support its network of participants. Appropriate economic and other incentives could be allowed to enable a fully functional ecosystem that can support SME listings. Stock exchanges can provide such incentives, as with the example of the mandatory requirement for an assigned market maker and lower trading fees for market makers in return for minimum requirements in order to build deeper markets (e.g. the NewConnect market at the Warsaw Stock Exchange¹⁴).

4. The SME educational gap

57. **SMEs are faced with an educational gap that is prominent when it comes to issuing bonds, privately placing debt or tapping the equity markets.** This is mainly demonstrated through a lack of awareness about the alternative means of finance available through the markets, coupled with a lack of skills required to face the process of issuance. Incomplete information and limited understanding result in discouraged seekers of finance, driving down demand for such products. Moreover, there may also be a lack of visibility as SMEs are often incapable of appropriately formulating and marketing their projects to the supply side; this reduces the spectrum of their investor base.

58. **Promoting financial education and building of skills is necessary for SMEs to overcome this educational gap** and raise awareness of their financing options through capital market instruments. SMEs need a skillset that will allow them to assess the appropriateness of equity vs. debt finance for their business model, evaluate their options and respond to market requirements. The required skillset consists of accounting, financial reporting, business planning, forecasting and budgeting, investor relations capabilities, tax planning and other. In addition to educational and awareness limitations, The reluctance of some SMEs to raise public financing can be due to fear of losing control of the business to shareholders, or due to the discouraging effects of previous rejections on other financing instruments.

59. On the supply side, too, the lack of equity culture and awareness has a significant negative impact on certain SME markets, limiting their depth and breadth and restricting the provision of a sustainable flow of investment into SME market-based finance. **Financial education of both SMEs and (mostly retail) investors is clearly the best, but not the only, way to induce participation in some SME markets** like the public equity markets. The ability and willingness of retail investors to place savings or allocate part of their pension funds in capital markets can be promoted through the use of mutual funds, exchange-traded funds, and retail brokerages specialised in small public equities. However, the benefits of such widening of participation by retail investors must be balanced against concerns for financial consumers arising from the high level of riskiness of investment in SME public equity. Robust financial consumer protection and education would need to accompany the sale of such products, explaining the risks of such instruments and the benefits of diversified savings portfolios.

60. **Governments can induce further participation of SMEs in public markets by bridging the educational gap of small companies** when it comes to capital market financing, **raising their awareness** of public financing options available and appropriate to them and equipping them with the skills necessary

¹⁴ See <http://www.newconnect.pl/index.php?page=1125>.

to tap the capital markets. Companies need to be educated so as to increase demand for risk finance by the SMEs themselves, particularly in an environment of below-trend bank lending. **The industry has also an important role to play in educating SMEs and raising their awareness around the existence and suitability of market-based financing.** The ELITE¹⁵ platform launched by the London Stock Exchange Group is an interesting example of an educational programme that can both enhance financial capabilities and also induce cultural change for participating SMEs, by building relationships with the wider ecosystem and fostering organisational changes that allow the company to benefit from a potential equity listing further down the line. The recently launched Deutsche Börse Venture Network¹⁶ is another interesting example of a programme designed to connect growth companies with professional investors. Local “house banks” can be incentivised so as to leverage their influential role and strategic relationships with SMEs and guide them towards alternative financing instruments, if and when appropriate.

5. Economic viability of market-based SME finance

61. **Small-sized deals in the capital markets are faced with important limitations in terms of their economic viability,** both on the debt and the equity side. Financial instruments issued directly by SMEs in the capital markets suffer from **structural cost disadvantages that are due to the small size** of the majority of corresponding potential transactions and their heterogeneous nature. Such limitations are manifested in terms of cost and deal economics, intrinsic risk assessment due to the lack of transparent but also in terms of standardised information provision, financial sophistication and reporting capabilities, communication and visibility. Syndicating and bundling techniques, such as securitisation, can therefore be considered as a potential solution to the SME financing issue.

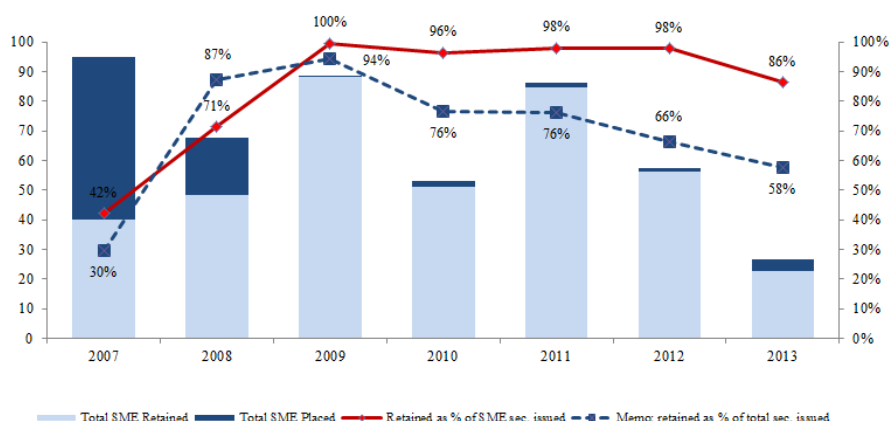
62. **Issuers of SME ABS in some parts of the world currently opt for cheaper central bank liquidity rather than placement of such rather complex products with investors in the primary market.** Official sector schemes providing funding at favourable terms may render securitisation as refinancing instrument relatively expensive. In Europe, most SME securitisation issued in the aftermath of the crisis was retained and used as collateral with the ECB, while very little was actually placed with private investors, usually just the senior, less risky, part of the structure (Figure 8). Besides regulatory treatment, asset quality considerations, low liquidity (and associated liquidity premia) and other factors may result in yield levels required by investors that cannot be serviced by the cash flows of the asset pool, rendering public issuance uneconomic.

63. **SME securitisation is regarded as uneconomic by some issuers due to the mismatch of the yield required by investors and the return on the underlying asset for the issuer.** The economics of SME securitisation issuances can be particularly unfavourable when issuance involves legacy (pre-crisis) loans carrying low spreads, against current yields demanded by investors (ECB and BoE, 2014b). Such yields incorporate compensation that covers for greater liquidity risk appreciation, perceived riskiness of the underlying loans given macroeconomic outlooks and other factors, including regulatory charges. As a result, for SME securitisation to be rendered economically viable and profitable, spreads charged on SME loans by originators would need to increase and/or the desired yield expected by investors to decrease.

¹⁵ See <http://www.lseg.com/areas-expertise/our-markets/borsa-italiana/equities-markets/raising-finance/elite>.

¹⁶ Launched on 11 June 2015; see <http://www.venture-network.com/dbvn-en/>.

Figure 8. SME Securitisation in Europe: placed vs. retained



Source: OECD (2015), calculations based on AFME, Bloomberg Dealogic, SIFMA,, and Thomson Reuters.

64. **When it comes to SME equity offerings, SMEs are faced with high issuance costs when targeting the main markets.** The establishment of specialised growth platforms with proportionate listing requirements are an effective way to address this, while the provision of appropriate economic incentives to the rest of the market participants would enable a fully functional ecosystem that can support SME listings. One-size-fits-all regulation and stock market structures on main markets cannot equally serve large and small stocks, while a proportionate approach with regard to listing rules, regulation and supervision could encourage public equity issuance for small companies and lower the corresponding costs. Importantly, however, any attempt to lower the requirements for small company equity issuances in terms of transparency, corporate governance or disclosure could diminish investor protection and by consequence market appetite for such instruments. To address this risk, the application of proportionate requirements for smaller issuers could involve different, but not necessarily lower, requirements, and in some areas might call for higher standards for small caps as compared to large caps.

65. **Insufficient economic incentives for intermediaries and advisors hinder the establishment of a supporting ecosystem.** According to one study, lower trading spreads and tick sizes (minimum price variation) intended to bring down transaction costs may be partly responsible for the decline in US equity offerings (Weild *et al.*, 2013).¹⁷ A one-cent tick size for all shares was found to reduce the economic incentives of intermediaries who facilitate small company IPOs and new capital formation, while also supporting their aftermarket activity. Higher tick sizes, in addition to higher commissions to market stocks to retail investors, could thus incentivise market-making especially for smaller shares, which in turn would improve liquidity. The impact of tick sizes on the supply of IPOs illustrates the pitfalls of one-size-fits-all regulation for every stock irrespective of size, liquidity and other characteristics.

66. **Pure for-profit stock exchange models could also sometimes cause perverse incentives to the detriment of the respective ecosystem.** For example, the replacement of quote-driven markets, supported by market-makers, by electronic order books could be more profitable for the exchange itself but profits are potentially siphoned off the ecosystem and market-makers would then be left with only the most thinly traded stocks of the market – likely including many SME stocks. Driving out market makers could

¹⁷ This study led by David Weild, former vice chairman of the Nasdaq Stock Market, reviewed Weild and co-author Edward Kim’s involvement in events leading up to the JOBS Act in the United States, providing their views on IPO markets throughout the world, and was sponsored by Grant Thornton LLP.

undermine the ecosystem as a whole and deprive the marketplace of liquidity in stocks such as those of SMEs that are less easy to match and impede their price discovery.

6. *Asymmetric tax treatment of debt and equity*

67. **Asymmetries in the tax treatment of equity and debt can create debt biases against equity, favouring debt.** Both debt and equity finance have an important role to play in the sustainable financing of the real economy. The tax deductibility of interest payments on debt in most jurisdictions puts equity issuance at a disadvantage. Even SMEs with highly levered capital structures may be driven to seek additional bank lending because of such favourable tax treatment of debt – besides other reasons like their lack of awareness of or access to other appropriate sources of financing. Furthermore, a mixture of mezzanine structures available in the European corporate lending market, carrying higher interest rates in special structures, have been used to provide de facto equity in de jure loan structures with favourable tax treatment.

68. **A potential reduction of some asymmetric treatment of tax for debt and equity, for the demand as well as the supply side, could potentially support the development of equity markets.** On the demand side, entrepreneurs are likely to include tax considerations in their choice of financing instruments. Different instruments are needed depending on the different stages of the life and characteristics of an SME. If the tax system somehow distorts the choice in favour of debt this may potentially lead to suboptimal outcomes. Such potential distortions are typically introduced through tax deductibility of interest payments, but also through double taxation of equity in some jurisdictions.

69. **On the supply side, tax considerations play an important role in institutional and retail investors' portfolio allocation** (provided that they choose among investments of equal risk-return characteristics). Investment-driven tax reliefs, perhaps by providing tax incentives, could induce long-term investment into SMEs. Tax relief is indeed the most commonly cited incentive by market participants, and examples of such practices have proven to accelerate the development of respective equity markets for SMEs. In the United Kingdom, for example, a number of tax-advantaged venture capital schemes and tax reliefs incentivise individual investors in the UK to invest in small growing businesses which would otherwise struggle to access finance (British Business Bank, 2014).¹⁸ At the same time, **tax incentives cannot overcome the structural cost disadvantage of small-sized deals** (whether they are debt or equity), **might introduce distortions with unintended consequences (e.g., underpricing of risk)** and create vested interests by providing benefits that go directly to the beneficiaries' profits. It is doubtful whether tax relief and other across the board regulatory incentives are sustainable and efficient to resolve structural SME problems. "Smarter" deal-oriented solutions could more effectively address the structural cost disadvantage of small-sized deals, as with the example of the EIF's European Angels Fund co-investment scheme.

70. **The benefits of tax neutrality between debt and equity expand beyond SME financing and are associated with a healthier financial structure, inclusive long-term growth and stability of the system.** Empirical evidence by the OECD suggests that "in most OECD countries more debt is typically associated with slower growth, while more stock market financing generates a positive growth effect" (Cournède *et al.*, 2015). Tax reforms that will make the choice between debt and equity more neutral are

¹⁸ These are the Enterprise Investment Scheme, Seed Enterprise Investment Scheme, Venture Capital Trusts, relief for losses on investment, but also the abolition of stamp duty on purchases of shares made on equity growth markets and eligibility of SME equity shares in ISA accounts, as mentioned above. The French PEA-PME savings accounts also provide tax incentives for retail investors.

therefore deemed essential to encourage corporate funding through equity rather than lending, not only as a means to improve SME financing but also to support inclusive long-term growth.

7. An under-developed investor base for SME market-based finance

71. **The role of institutional investors (pension funds, insurance companies, sovereign wealth funds) in promoting market-based SME financing is both critical and essential**, as they can constitute the driving force in efforts made to foster custom SME financing instruments. The interest of institutional investors is based on a search for yield (particularly in the current persisting low-yield, low interest rate environment), asset risk diversification and long-term asset-liability matching. Their participation in SME financing has nevertheless not been sufficiently incentivised, while a number of hurdles prevent them from engaging further with the SME asset class.

72. **A number of ongoing regulatory reforms may run counter to fostering securitisation by disincentivising originators and long-term investors.** The regulatory environment around securitisation instruments is perceived as extremely challenging by institutional investors and may reduce their participation in that market. The final framework of the Basel Committee on Banking Supervision (BCBS) for securitisation, the European Insurance and Occupational Pension Authority's (EIOPA's) proposal on Solvency II capital charges for the instrument, and the implementation of the Liquidity Coverage Ratio are among those regulatory workstreams claimed by market participants to have a negative bearing on securitisation. Insurance companies are said to be particularly affected by the increased capital charges of Solvency II, and while some alleviation has been achieved compared to initial proposals, many market participants deem these regulations still as unduly onerous on both banks and investors.

73. In addition, **lack of consistency** in the regulatory frameworks of similar investment instruments (securitised products vs. unsecuritised wholesale portfolio) may create an unlevel playing field for asset classes with similar characteristics (same underlying exposure), both at the domestic and at the international level. Inconsistent treatment of closely related instruments can create unintended biases favouring some instruments at the expense of their alternatives. **A more holistic and system analysis of the impact of the entire set of regulations affecting the SME asset class is therefore warranted.**

74. **The improvement of data and analytics** discussed above as the most prominent problem across the board is an enabling factor for deeper involvement of long-term investors. The investor pool currently active in the SME space is dominated by large institutional investors who have developed their own credit assessment capabilities and infrastructure. Better and more standardised information availability would lower the costs of monitoring and evaluating SME risk, allowing for more institutional involvement in the asset class.

75. **The lack of liquidity in secondary markets** is another obstacle for investors, not so much in the private placements market which is a structurally illiquid market, but mostly in the public equity markets. The important role of market-makers and the existence of a healthy and vibrant ecosystem that have been previously discussed (Section II.3) may deserve to be further discussed. Limited coverage of small floated companies by equity research analysts inhibits the wider participation of institutional investors, restraining liquidity. Many professional investors may not engage in a trade on either primary or secondary markets without relevant research being available. Lack of equity research for small quoted companies adds to the information deficit around SMEs, a prominent structural impediment to their access to finance across financial instruments and markets. Syndication or club deals/aggregation funds structured by lead investors could be a way for a broader number of investors to participate in such markets.

76. **Capital markets, particularly in Europe, remain relatively fragmented for SMEs and mid-caps**, with low levels of cross-border investment by foreign investors in securities other than “blue chips”. This is mainly attributed to obstacles such as different securities laws, bankruptcy laws and tax incentives, but also due to investors’ tendency to discriminate between the different types of bonds depending on the perceived quality of the underlying collateral. The European Commission’s Capital Markets Union initiative is a positive step forward and addresses fragmentation in SME financing markets, removing constraints of market segregation (EC, 2015). The benefits of such market access can theoretically be passed on to small borrowers at the time of origination. Public intervention through the provision of guarantees or credit enhancement on SME securitisation transactions, where deemed warranted, may further assist in the correction of imbalances of fragmented markets.

77. **Retail investor participation in SME financing through the right platforms and with the required investor protection attached is currently underdeveloped** although it would be an abundant source of capital for small deals. Retail investors need to be motivated and incentivised to seek exposure in SME market-based instruments. For pension fund investments, for example, default pension plan solutions could include appropriate shares of SME equity in the equity portfolio part as long as the risk-return profile is beneficial for pension plan members. This could, for example, be further developed on the basis of the OECD roadmap for the good design of defined contribution pension plans.¹⁹ While promotion of SME listed shares to retail investors might be a way to enhance market liquidity, appropriate safeguards would need to be put in place for their protection. Although active retail investor participation could provide much sought-for liquidity for small listed shares, risks of inappropriate sales practice and abuses may occur. This highlights the need for safeguards in particular in light of the riskiness of SME public equity and the costs that a potentially broader damage to confidence in markets may incur. Such concerns must be balanced against the benefits of retail participation in SME public equity, as mentioned above. The right balance needs to be achieved between maintaining retail participation alongside wholesale and institutional investors in the SME equity space and appropriate investor protection mechanisms for retail investors.

78. **Addressing the above stumbling blocks in the participation of patient capital and retail investors in SME financing will allow those instruments to be seen as less of niche products**, better integrated into the broader capital markets. Widening the SME investor base and diversifying their portfolios will not only foster financing for SMEs but will also assist in the creation of a sounder financial system through better risk sharing within the economy.

III. CONCLUDING REMARKS AND POLICY IMPLICATIONS

79. In order to enhance, and benefit from, the opportunities for capital market financing for SMEs, the constraints of market-based financing channels need to be better understood and addressed as appropriate. By addressing stumbling blocks that often have common, SME-specific features and affect a number of financing instruments and markets, SMEs can become an asset class that is more “investable” and reached by institutional investors as well as retail investors. Making SME investments that typically yield above-market returns available to a broad range of investors is particularly relevant in the current protracted low interest-rate environment.

¹⁹ See <http://www.oecd.org/daf/fin/private-pensions/designingfundedpensionplans.htm>.

80. Several actions can be taken to mitigate the constraints facing capital market-based SMEs financing and enhance its potential. These measures can be clustered around three main pillars of action:

1. **Support the market infrastructure around SME market-based funding:** set up and maintain central depositories of high quality and easily accessible information around SME creditworthiness through public initiative, standardise product offerings and processes, encourage tax-neutrality between debt and equity, nurture vibrant and healthy SME-specific ecosystems, ensure a coordinated approach on regulation and a level playing field across products with similar characteristics.
2. **Facilitate and induce the use of market-based finance by the SMEs themselves:** bridge the educational gap that SMEs are facing, raise their awareness of capital market financing options for SMEs and equip them with the skills required for them to tap the public markets, secure proportionate access costs in a number of ways – including the establishment of SME-specific trading platforms or the standardisation of custom products tailored to SMEs needs.
3. **Promote the currently underdeveloped investor base, catalysing long-term institutional investor participation in the SME asset class:** address any unwarranted regulatory impediments to the participation of long-term investors in SME markets, enhance transparency to allow for informed decision-making by patient capital holders, address fragmented markets to stimulate long-term investor appetite and participation on a cross-border basis. Also encourage the channelling of retail investor funds into SME instruments, for example through pension funds, with the relevant investor protection safeguards.

These measures are not intended to be mandatory or binding but represent instead potential actions that could be undertaken to support market-based financing of SMEs. Governments should have discretion as to the adoption of any these measures, taking into account their domestic circumstances and other policies.

81. **There is a role for policymakers to alleviate such constraints and enable wider and deeper capital market financing for SMEs, as appropriate.** Promotion of market-based SME finance will not, however, disengage banks from SME financing, but rather complement bank lending and other financing alternatives. The role of SME specialised banks or “house banks” could be broadened so as to facilitate public market funding for SMEs by acting as advisors and as educators raising their SME clients’ awareness of such tools. **In the context of a closely interconnected SME financing environment, a holistic and coordinated effort by all market constituencies involved (investors, intermediaries, advisors, policy makers and SMEs) is required** to support investment in the SME asset class and allow SMEs to fully benefit from capital market financing when and as appropriate, without posing a risk to financial stability.

82. The debate on access to finance tends to concentrate on the importance of loans and guarantees, with the equity and debt markets being often an afterthought. **Even if public markets are perhaps not suitable for all types of SMEs or for all types of investors,** as was argued in this report, the promotion of public SME markets in public opinion can help foster innovation and job creation by channelling funds to credit-seeking SMEs with the appropriate characteristics. Governments and regulators are therefore called to **promote public awareness around market-based SME finance and make it a prominent part of the SME finance dialogue, alongside bank lending.**

Figure 9. Main areas of constraints for market-based SME financing and potential policy actions: three pillars of recommendations

POLICY TARGET	MAIN AREA OF CONSTRAINTS	POTENTIAL POLICY ACTION
MARKET INFRASTRUCTURE	Data paucity, information provision	<ul style="list-style-type: none"> Encourage the build-up of loan-level data, performance track records, financial reporting and data sharing Set up and maintain central depositories of high quality and easily accessible information around SME creditworthiness through public initiative
	Standardisation	<ul style="list-style-type: none"> Standardise data, processes and product offering Develop standardised “off-the-shelf” versions of financing instruments tailored to SME needs (lower costs, increase efficiency and accessibility to SMEs and investors)
	SME ecosystems	<ul style="list-style-type: none"> Nurture vibrant and healthy SME-specific capital market ecosystems Provide economic or other incentives to indispensable market constitutencies (e.g. market makers providing liquidity)
SMEs	Education gap	<ul style="list-style-type: none"> Raise awareness of capital market financing options for SMEs (among SME entrepreneurs as well as smaller local financial institutions traditionally serving SMEs) Promote financial literacy to bridge the SME education gap, equip them with skills required to tap the capital markets, respond to market requirements and public scrutiny Co-operate with private sector institutions in improving the visibility of successful transactions and platforms for SME financing instruments
	Cost of issuance and other requirements	<ul style="list-style-type: none"> Secure proportionate requirements, access and costs for SME capital market financing Promote the establishment of SME-specific trading platforms Promote the standardisation of custom products/ processes tailored to SMEs
	Tax imbalances	<ul style="list-style-type: none"> Encourage tax-neutrality between debt and equity
INVESTORS	Underdeveloped investor base	<ul style="list-style-type: none"> Enhance transparency and sharing of information to allow for informed decision-making by capital holders Encourage the channeling of retail investor funds into SME instruments for example through pension funds, with the relevant investor protection safeguards Critically evaluate the potential impact from the provision of incentive schemes targeted to SME instruments, particularly to investors but also to SMEs (e.g. tax incentives)
	Limited buy-in by long-term institutional investors	<ul style="list-style-type: none"> Catalyse long-term institutional investor participation in the SME asset class, addressing any regulatory impediments to their participation in SME financing Consider public incentives or assistance for investors to set up appropriate internal infrastructures (SME loan due diligence capacity, models, monitoring systems) for the due diligence and evaluation of SME risk Address fragmented markets to stimulate long-term investor participation on a cross-border basis
	Regulation	<ul style="list-style-type: none"> Promote a holistic and coordinated approach to regulation on a relative basis to avoid distortions in risk pricing Ensure a level playing field across financing instruments with similar characteristics Promote the establishment of solid regulatory frameworks for instruments such as covered bonds and private placements to stimulate investor appetite

Source: OECD Secretariat.

REFERENCES

- AFME - Association for Financial Markets in Europe (2015), *Bridging the growth gap*, February 2015; available at www.afme.eu/WorkArea/DownloadAsset.aspx?id=12509.
- Altenburg, M. (2013), *Verbriefungen: Überlegungen zum Baseler Konsultationspapier, Kreditwesen* 12/2013.
- Berger, A., and G. Udell (2003), *The economics of small business finance: The roles of private equity and debt markets in the financial growth cycle*, *Journal of Banking and Finance* 22, 1998, available at doi:10.1016/S0378-4266(98)00038-7
- British Business Bank (2014), *British Business Bank: How medium-sized businesses access finance: Lessons for tomorrow's medium-sized businesses*; available at <http://british-business-bank.co.uk/wp-content/uploads/2014/05/13-035831-01-Access-to-Finance-report-130514-Final-pdf.pdf>.
- BoE – Bank of England (2014a), *Should the availability of UK credit data be improved? A Discussion Paper*, May 2014, available at www.bankofengland.co.uk/publications/Documents/news/2014/dp300514.pdf.
- Carey, M., S. Prowse, J. Rea, and G.F. Udell (1993), *The economics of private placements: A new look*, *Financial Markets. Institutions and Instruments* 2.
- Cournède, B., O. Denk and P. Hoeller (2015), *Finance and Inclusive Growth*, OECD Economic Policy Paper, June 2015, No 14, available at [10.1787/2226583x](http://dx.doi.org/10.1787/2226583x).
- EBA (2014b), *EBA discussion paper on simple standard and transparent securitisations: Response to the Commission's call for advice of December 2013*; available at www.eba.europa.eu/documents/10180/846157/EBA-DP-2014-02+Discussion+Paper+on+simple+standard+and+transparent+securitisations.pdf.
- EC – European Commission (2015), *Green Paper: Building a Capital Markets Union, COM(2015) 63 final*; available at http://ec.europa.eu/finance/consultations/2015/capital-markets-union/docs/green-paper_en.pdf.
- ECB and BoE – European Central Bank and Bank of England (2014a), *The impaired securitisation market: causes, roadblocks and how to deal with them*, April 2014, available at www.ecb.europa.eu/pub/pdf/other/ecb-boe_impaired_eu_securitisation_market.en.pdf.
- ECB and BoE – European Central Bank and Bank of England (2014b), *The case for a better functioning securitisation market in the European Union. A discussion paper*, May 2014, available at www.ecb.europa.eu/pub/pdf/other/ecb-boe_case_better_functioning_securitisation_market.en.pdf.

- ECBC – European Covered Bond Council (2013), *2013 European Covered Bond Factbook*, available at www.ecbc.eu/.
- ICMA – International Capital Market Association (2015), *Pan-European Corporate Private Placement Market Guide*, February 2015, available at <http://www.icmagroup.org/Regulatory-Policy-and-Market-Practice/Primary-Markets/private-placements/the-pan-european-corporate-private-placement-market-guide/>.
- International Finance Corporation (2012), *Credit reporting knowledge guide*, available at www.ifc.org/wps/wcm/connect/industry_ext_content/ifc_external_corporate_site/industries/financial+markets/publications/toolkits/credit+reporting+knowledge+guide.
- Isaksson, M. and S. Çelik (2013), *Who Cares? Corporate Governance in Today's Equity Markets*, *OECD Corporate Governance Working Papers*, No. 8, OECD Publishing, available at [10.1787/5k47zw5kdnmp-en](https://doi.org/10.1787/5k47zw5kdnmp-en).
- Meyers, L.H. (1998), *The present and future role of banks in small business Finance*, *Journal of Banking and Finance* 22, 1998, available at doi:10.1016/S0378-4266(98)00019-3
- Miller, M. (Ed.) (2003), *Credit Reporting Systems and the International Economy*, MIT Press.
- Nassr, I.K. and G. Wehinger (2015), *Unlocking SME finance through market-based debt: Securitisation, private placements and bonds*, *OECD Journal: Financial Market Trends*, available at [10.1787/fmt-2014-5js3bg1g53ln](https://doi.org/10.1787/fmt-2014-5js3bg1g53ln).
- OECD (2015), *OECD Business and Finance Outlook*, OECD Publishing, Paris, available at [10.1787/9789264234291-en](https://doi.org/10.1787/9789264234291-en).
- OECD (2010), Discussion Paper on Credit Information Sharing, available at www.oecd.org/investment/psd/45370071.pdf.
- OECD (2015), *Opportunities and Limitations of Public Equity Markets for SMEs*, internal document [DAF/CMF(2015)12], revised version forthcoming in *OECD Journal: Financial Market Trends*.
- Pratt, E.S., and J.K. Morris (1987), *Pratt's guide to venture capital sources*, Venture Economics, Inc., Wellesley, 1987.
- Stiglitz, J. and A. Weiss (1981), "Credit rationing in markets with imperfect information", *American Economic Review*, Vol. 71, No. 3, pp. 393-410.
- Wehinger, G. (2012), *Bank deleveraging, the move from bank to market-based financing, and SME financing*, *OECD Journal: Financial Market Trends*, Vol. 2012/1, available at [10.1787/fmt-2012-5k91hbvf9g3](https://doi.org/10.1787/fmt-2012-5k91hbvf9g3).
- Wehinger, G. (2014), *SMEs and the credit crunch: Current financing difficulties, policy measures and a review of literature*, *OECD Journal: Financial Market Trends*, Vol. 2013/2. DOI: <http://dx.doi.org/10.1787/fmt-2013-5jz734p6b8jg>.
- Weild, D., E. Kim and L. Newport (2013), *Making Stock Markets Work to Support Economic Growth: Implications for Governments, Regulators, Stock Exchanges, Corporate Issuers and their Investors*, *OECD Corporate Governance Working Papers*, No. 10, OECD Publishing, available at <http://dx.doi.org/10.1787/5k43m4p6ccs3-en>.

ENDNOTE

¹ The set of global IPOs in this and the following figures comprises of listings on: Abu Dhabi Securities Exchange, Aktie Torget, Alberta Stock Exchange, Alternext Paris, Athens, Australian Securities Exchange, Bahrain (Manama), Bangkok, Barcelona Stock Exchange, BATS Exchange, Belgrade Stock Exchange, Berlin, Berne Stock Exchange, BM&F Bovespa SA, Bogota, Bolsa Mexicana de Valores, Bombay, Borsa Istanbul, Borsa Italiana S.P.A., Budapest, Buenos Aires, Cairo, Canadian Securities Exchange, Casablanca, Colombo, Copenhagen, Cyprus Stock Exchange, Dhaka Stock Exchange Ltd, Dubai Financial Market, Dublin, Euronext Amsterdam, Euronext Brussels/Lisbon/Paris, Frankfurt, Greta Securities Market, Hanoi Stock Exchange, Helsinki, Hong Kong, Indonesian Stock Exchange, JASDAQ, Johannesburg, Jordan (Amman), Korea Stock Exchange, Kuala Lumpur, London Alternative Market, London Stock Exchange, Malta, Moscow, NASDAQ, NSE, NYSE, Oslo Bors, Plus Markets (London), Prague, Qatar Exchange, Reykjavik, Riga, Romania (Bucharest), Santiago, Sapporo (JP), Saudi Stock Exchange, Shanghai, Shenzhen, Singapore, SIX Swiss Exchange, Sofia, Taiwan Stock Exchange, Tel Aviv, Tokyo, Toronto, TSX Venture Exchange, Vietnam Stock Market, Warsaw Stock Exchange, Wellington, Zagreb.

Footnote by Turkey: The information in this document with reference to “Cyprus” relates to the southern part of the Island. There is no single authority representing both Turkish and Greek Cypriot people on the Island. Turkey recognises the Turkish Republic of Northern Cyprus (TRNC). Until a lasting and equitable solution is found within the context of the United Nations, Turkey shall preserve its position concerning the “Cyprus issue”.

Footnote by all the European Union Member States of the OECD and the European Union: The Republic of Cyprus is recognised by all members of the United Nations with the exception of Turkey. The information in this document relates to the area under the effective control of the Government of the Republic of Cyprus.