This document contains the third and final version of the support note on diversification of financial instruments for SMEs. It has been revised based on several rounds of comments provided by the G20/OECD Task Force on Institutional Investors and Long-term Financing and the G20 IIWG meetings. This note was considered by G20 Finance and Central Bank Deputies at their meeting in Xiamen, China, who agreed to transmit it to G20 Finance Ministers and Central Bank Governors and G20 Leaders at their July and September meetings, respectively.

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EXECUTIVE SUMMARY

Bank lending is the most common source of external finance for many SMEs and entrepreneurs, which are often heavily reliant on straight debt to fulfil their start-up, cash flow and investment needs. While commonly used by small businesses, traditional bank finance poses challenges to some categories of SMEs and may not be the most appropriate form of finance at specific stages in the firm life cycle. In particular, debt financing appears to be ill-suited for newer, innovative and fast growing companies with a higher risk-return profile and few pledgeable assets, which typically face a “growth capital gap”. Capital gaps exist also for companies seeking to internationalise and to effect important transitions in their activities, such as ownership and control changes, structures, or to de-leverage and improve their capital structures, or for larger SMEs growing into intermediate-sized enterprises.

In the aftermath of the 2008-09 global financial crises, as banks have been contracting their balance sheets in order to meet more rigorous prudential rules, the credit constraints experienced by SMEs in many countries further highlighted the vulnerability of the SME sector to changing conditions in bank lending and regulations.

Recognising the complementary nature of the role of banks and other financing channels, the G20/OECD High-level Principles on SME Financing call for strengthening SME access to traditional bank financing and improving their access to a broad range of financing instruments, to enable them to obtain the form and volume of financing best suited to specific needs and stage of the firm life-cycle. Multiple and competing sources of finance for SMEs should be supported, including asset-based finance, alternative forms of debt, hybrid tools and equity instruments. Capital market financing can offer the possibility to tap into a broad range of funding sources, including institutional investors, to support SME innovation and growth, provided an appropriate measure and management of associated risks are conducted. At the same time, capital markets, which typically seek opportunities for higher returns than in traditional debt markets, are not an appropriate source of finance for all SMEs. Equity finance holds particular promise for companies that have a high risk-return profile, such as new, innovative and high growth firms. Seed and early stage equity finance can boost firm creation and development, while other equity instruments, such as specialised platforms for SME public listing, can provide financial resources for growth-oriented SMEs.

A number of challenges persist that limit banks’ capacity to lend to small businesses and SMEs’ uptake of non-bank-finance instruments, most of which are currently at the reach of only a small share of SMEs. On the demand side, many entrepreneurs and business owners lack financial knowledge, strategic vision, resources and sometimes even the willingness or awareness to successfully attract finance other than straight debt. The lack of appetite by SMEs for alternative financial instruments, equity in particular, can also in parts be attributed to their tax treatment vis-à-vis straight debt. On the supply side, potential investors face an overall opacity of the SME finance market, which is characterised by large information asymmetries and a scarcity of transparent credit data, a lack of exit options, as well as regulatory impediments. As a consequence of these obstacles, financial instruments for SMEs often operate in thin, illiquid markets, with a low number of market participants, which, in turn drives down demand from SMEs and discourages potential suppliers of finance.

The development of diversified financing instruments and markets for SMEs requires appropriate framework conditions, in terms of regulation, taxation, transparency and connectivity. In particular, SME
equity markets rely on specialised ecosystems which foster links between growth-oriented companies and a variety of specialised financial institutions and service providers.

Governments, international organisations, multilateral development banks (MDBs) and other stakeholders have a variety of policy options at their disposal to address these challenges, including regulatory tools, the enhancement of credit risk information infrastructures, financial literacy schemes, investor-readiness programmes, initiatives to improve SME linkages with the investor community and policies to leverage private resources, among others.

A holistic approach is needed to address demand- and supply-side obstacles in tandem, taking into account diverse circumstances and different economic, social and regulatory environments. The development of Effective approaches for the implementation of the voluntary G20/OECD High-Level Principles on SME Financing will support governments in identifying and designing appropriate policy measures in ways suited to their national contexts and challenges of their SME population.

1. Framework and preconditions

The development of healthy and responsive financial markets relies on suitable framework conditions, set out in the Progress Report on the Diversification for Financing Instruments for Infrastructure. For the diversification of SME financing instruments, there may be additional specific considerations in terms of regulation, taxation, transparency and connectivity. The growth orientation of SMEs as well as their capacity to approach non-bank financing channels should also be taken into account.

Financing instruments alternative to straight debt typically alter the traditional risk-sharing mechanism of debt contracts, implying higher risks for the financiers, in the expectation of higher returns. Against this backdrop, a sound regulatory environment, which ensures investor protection and financial stability, while supporting a range of financing instruments for SMEs, represents a key enabling factor for the diversification of SME financing sources. Regulatory certainty is especially important to ensure a predictable and stable operating environment for firms and investors. Efficient insolvency procedures and strong right enforcement mechanisms can increase the confidence of a broad range of investors in SME markets.

Transparency in SME finance markets is needed to attract investors and help them identify investment opportunities, particularly in the riskier segment of the market, including equity finance. By providing an accurate reflection of the risk involved in SME finance, disclosure requirements and practices and information infrastructures for credit risk assessment can reduce the financing costs for SMEs, which are typically larger than for large firms.

Interconnectedness of financial markets, across investment segments and constituencies, is another important factor for the development of financing opportunities for growth-oriented SMEs. Connectivity enhances information flows and transparency, increases liquidity in SME finance markets, contributes to opening profitable exit options for investors and provides opportunities for follow-on finance for early stage ventures. Connectivity of diverse financing sources with the banking system is also crucial for the long-term development of alternative instruments. Indeed, most alternative financing tools should be regarded as complementary, rather than competitive, to bank financing.

A well-functioning banking system represents a pre-condition for the development of most alternative financing tools, including innovative instruments, such as crowdfunding, which requires a well-established infrastructure for payments, as well as information about the creditworthiness of entrepreneurs.

Across alternative financing markets, suitable framework conditions need to be matched by adequate financial skills on the demand side. Broad awareness about financing sources for diverse business needs
and financial skills development are preconditions for SMEs’ financing diversification strategies and the uptake of most financial instruments other than straight debt. The quality of investment and entrepreneurial projects are especially important for attracting equity investors.

Turning to public equity, the development of these markets relies on specialised platforms linking growth-oriented companies with a variety of specialised financial institutions and service providers. This is especially important for SMEs, which typically require support for small-sized transactions and advice at the issuance/listing stage and in the aftermarket. In public equity markets, SME-specialised ecosystems consist of investment banks, SME-specialised banks, research analysts, sales, brokers, market makers and other third party advisors focused on SMEs, including legal and financial advisors (see Figure 1).

Figure 1. A valuable ecosystem for SME equity offerings


Furthermore, for SME equity markets to work and grow, an entrepreneurial business environment, which enables business creation, innovation and growth, is needed. Equity investors need a critical mass of high-growth opportunities, to screen and select appropriate ventures and business models with growth potential. A critical mass of investment opportunities is also crucial to overcome the problems of liquidity which have limited equity markets development in many countries. Therefore, a generalised culture of risk-taking, social recognition for an entrepreneurial career, low barriers to market entry by new entrepreneurs and high levels of appropriateness of the returns from innovation are all factors that favour
opportunities for equity investment to emerge. Also, access to knowledge and skills for entrepreneurs to launch innovative businesses is crucial. These are not confined only to high-tech sectors, for which good linkages with R&D centres and universities are essential, but may concern traditional or mature industries, in which opportunities to rapid growth may exist for innovative start-ups.

2. Diversifying financing instruments for SMEs

2.1 Strengthening SME access to traditional bank financing

Diverse financing instruments are needed to serve adequately diverse types of businesses and their different financing needs along the business life cycle. Traditional debt finance – bank loans, overdrafts, credit lines and the use of credit cards – is the most common source of external finance for many SMEs and entrepreneurs, serving their working capital needs, as well as investment purposes. Also, in many cases, it represents an essential complement to other types of financing, including equity. However, specific challenges limit traditional bank lending to SMEs, related to the greater difficulties that lenders encounter in assessing and monitoring SMEs relative to large firms. Asymmetric information is a more serious problem in SMEs than in larger firms, since SMEs often do not produce audited financial statements that yield credible financial information. Furthermore, in smaller enterprises, the line of demarcation between the finances of the owner(s) and those of the business is usually blurred. Also, the principal/agent problem inherent in all financing operations is particularly acute in the case of SMEs, which may undertake projects that are deemed excessively risky by the lender. Against this backdrop, lack of credit history and collateral often result in severe credit constraints for SMEs.

2.2 Broadening the range of financing instruments available to SMEs

While bank financing will continue to be crucial for the SME sector, a more diversified set of options for SME financing is needed to support long-term investment and reduce the vulnerability of SMEs to changes in the credit market. In this regard, equity finance holds particular promise for companies that seek long-term corporate investment, to sustain innovation, value creation and growth (Table 1).

Table 1. Alternative external financing techniques for SMEs and entrepreneurs

<table>
<thead>
<tr>
<th>Low Risk/Return</th>
<th>Low Risk/Return</th>
<th>Medium Risk/Return</th>
<th>“Hybrid” Instruments</th>
<th>High Risk/Return</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Asset-Based Finance</strong></td>
<td><strong>Alternative Debt</strong></td>
<td><strong>Equity Instruments</strong></td>
<td><strong>“Hybrid” Instruments</strong></td>
<td><strong>Equity Instruments</strong></td>
</tr>
<tr>
<td>• Asset-based lending</td>
<td>• Corporate Bonds</td>
<td>• Private Equity</td>
<td>• Convertible Bonds</td>
<td>• Mezzanine Finance</td>
</tr>
<tr>
<td>• Factoring</td>
<td>• Securitised Debt</td>
<td>• Venture Capital</td>
<td>• Bonds with Warrants</td>
<td></td>
</tr>
<tr>
<td>• Purchase Order Finance</td>
<td>• Covered Bonds</td>
<td>• Business Angels</td>
<td>• Profit Participation Rights</td>
<td></td>
</tr>
<tr>
<td>• Warehouse Receipts</td>
<td>• Private Placements</td>
<td>• Specialised Platforms for Public Listing of SMEs</td>
<td></td>
<td></td>
</tr>
<tr>
<td>• Leasing</td>
<td>• Crowdfunding (debt)</td>
<td>• Crowdfunding (equity)</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>• Debt Funds / Loan Funds</td>
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</tbody>
</table>


Increasingly complex and interconnected financial markets offer opportunities to serve the diverse needs of SMEs and, in particular, to finance SME growth. Capital market financing can open the possibility to tap into a broad range of funding sources, including institutional investors. At the same time, not all financing instruments are suitable and of interest for all enterprises, depending on their risk-return profile, stage in the business life cycle, size, scale, management structure and financial skills (see Table 2).
To be effective, the financial system should supply financial resources to companies in varying circumstances and channel financial resources from different sources to business investments.

### Table 2. Suitability of alternative financing instruments for different firm profiles and stages

<table>
<thead>
<tr>
<th>Type of financing instrument</th>
<th>Profile and stage of firm</th>
</tr>
</thead>
</table>
| **Asset-Based Finance**     | • Start-ups  
• Firms with limited credit history and lack of collateral  
• Fast growing and cash-strapped firms  
• Firms with solid base of customers but high investments in intangibles  
• High-risk and informationally non-transparent firms  
• Firms changing their capital assets frequently  
• Producers and traders of commodities |
| **Alternative Debt**         | • Large to mid-size firms with stable earnings and relatively low cash flow volatility  
• Firms responding to reporting requirements linked to issuance  
• Firms undertaking investment or seizing growth opportunities  
• Firms that do not wish dilution of ownership and control  
• Smaller companies with limited visibility in public markets (private placements)  
• Firms lacking collateral or credit history (debt crowdfunding) |
| **“Hybrid” Instruments**     | • Young high-growth firms seeking cheaper expansion capital than VC and less dilution of control  
• Established firms with emerging growth opportunities  
• Firms undergoing transition and restructuring  
• Firms seeking to strengthen capital structure  
• Firms with well-established and stable earning power and market position |
| **Equity Instruments**       | **Business angel investments** • Firms in their seed and early investment stage  
• Innovative ventures requiring investment and business-building skills  
**Venture capital** • Firms in their seed, early and late investment stage  
• High-growth-potential firms, with capacity for high returns in a short time frame  
**Other private equity** • Mature businesses undertaking restructuring or ownership change  
• Distressed businesses with potential for rescue  
**Public equity** • Young, innovative and high-risk small firms  
• Firms with highly structured governance and management systems, and extensive disclosure |


#### 2.1 Asset-based finance

At the one end of the risk/return spectrum are financing instruments that sustain the short and medium-to-long term financing needs of SMEs, but rely on different mechanisms than traditional debt. This is the case of asset-based finance (e.g. asset-based lending, factoring, leasing), whereby a firm obtains cash, based not on its own credit standing, but on the value of specific assets, including accounts receivables, letters of credit, inventory, machinery, equipment and commodities.
The key advantage of asset-based finance is that firms can access cash faster and under more flexible terms than through conventional secured lending, regardless of their balance sheet position and future cash flow prospects. Furthermore, with asset-based finance, firms that lack a credit history, face temporary shortfalls or losses, or need to accelerate cash flow to seize growth opportunities, can access working capital in a relatively short time. On the other hand, the costs incurred and/or the complexity of procedures may be substantially higher than those associated with conventional bank loans, and funding limits are often lower than in the case of traditional debt.

Asset-based finance is widely used by SMEs across OECD countries, and increasingly in emerging economies and developing countries, to meet their working capital needs, support domestic and international trade, and, in some cases, for investment purposes. Trade finance and supply chain finance (i.e. reverse factoring) are increasingly relevant to enable SMEs to seize opportunities in global markets and support their participation in global value chains.

2.2 Alternative debt instruments

Alternative debt differs from traditional lending in that investors in the capital market, rather than banks, provide the financing for SMEs across countries. Alternative forms of debt, such as corporate bonds, have had only limited usage by the SME sector, even within the larger size segment which would be suited for structured finance and could benefit from accessing capital markets, to invest and seize growth opportunities. Corporate bonds typically require the issuer to have a certain size and scale, an established credit history and earnings record, and limited volatility on revenues and earnings.

Corporate bonds present some advantages for mid-sized firms that can meet the criteria requested by the market, and which can respond to the reporting requirements linked to bond issuance. In some countries, the regulatory framework allows private placements of corporate bonds by unlisted companies, which are subject to less stringent reporting and credit requirements.

Financing with corporate bonds can be an especially attractive option when market interest rates are low, as the coupon rates over the life of the bond can be set at a convenient rate, and still attract investors. Also, unlike equity, issuing bonds does not dilute ownership or the control of the company. In some countries, the regulatory framework allows private placements of corporate bonds, which are subject to less stringent reporting and credit rating requirements.

Among alternative debt instruments, securitisation and covered bonds are instruments for the refinancing of banks and for their portfolio risk management that allow banks to transform SME loans in their balance sheets into liquid assets, which can be used to increase lending itself. Through securitisation, various types of contractual debt are pooled and sold to investors, who acquire rights to receive the cash collected from the financial instruments that underlie the security.

Securitisation reduces the bank’s exposure to credit risk, which is transferred to the capital market. This has important implications in the light of the recent financial reforms (i.e. Basel III), as risky assets are taken out of the banks’ balance sheets and the capital to risk-weighted asset ratios is improved. Ultimately, by giving capital relief, securitisation reduces the bank’s total cost of financing. Covered bonds work similarly to securitised debt, except that assets remain on the issuer’s consolidated balance sheet. Thus, they cannot help to strengthen the issuer’s capital ratio. At the same time, because covered bonds are secured, they are considered to be less risky than unsecured bank bonds, which implies low-cost funding for the issuer.

Debt securitisation and covered bonds have developed at a high pace in the past decade, but came under scrutiny in the wake of the 2008-09 financial crisis, as a major driver of risk leveraging and financial
instability. The post-crisis deleveraging in the banking sector has contributed to reviving the debate about the need for a healthy, safe and high quality securitisation market to extend SME lending and measures have been introduced at different levels to re-launch the market, while avoiding the pitfalls of the past.

2.3 Crowdfunding

Crowdfunding has grown rapidly since the mid-2000s and at an increasing rate in the last few years, although it still represents a very minor share of financing for businesses. It has been used in particular by non-profit organisations and the entertainment industry, where non-monetary benefits or an enhanced community experience represent important motivations for donors and investors. Nevertheless, over time, crowdfunding has become an alternative source of funding across many other sectors, and it is increasingly used to support a wide range of for-profit activities and businesses. Furthermore, crowdfunding platforms are increasingly used by other investors across the risk/return spectrum (e.g. banks, business angels) to screen lending and investment opportunities and leverage funds with other financiers.

Peer-to-peer lending (debt crowdfunding) can be attractive for small businesses that lack collateral or a credit history to access traditional bank lending. Equity crowdfunding can provide a complement or substitute for seed financing for entrepreneurial ventures and start-ups that have difficulties in raising capital from traditional sources.

While the pace of technological developments has enabled a rapid diffusion of crowdfunding, the regulatory environment has limited the expansion of its use, especially for securities-based crowdfunding, which is still not legal in some countries. Nevertheless, exemptions to general rules to secure investors or the implementation of ad hoc regulation are increasingly observed across countries and are expected to facilitate the growth of the industry.

2.4 Hybrid instruments

Hybrid instruments, which combine debt and equity features into a single financing vehicle, represent an appealing form of finance for firms that are approaching a turning point in their life cycle, when the risks and opportunities of the business are increasing, a capital injection is needed, but they have limited or no access to debt financing or equity, or the owners do not want the dilution of control that would accompany equity finance. This can be the case of young high-growth companies, established firms with emerging growth opportunities, companies undergoing transitions or restructuring, as well as companies seeking to strengthen their capital structures. At the same time, these techniques are not well-suited for many SMEs, as they require a well-established and stable earning power and market position, and demand a certain level of financial skills.

In many countries, in recent years, with the support of public programmes, it has become increasingly possible to offer hybrid tools to SMEs with lower credit ratings and smaller funding needs than what would be the practice in private capital markets. Governments and international organisations mainly intervene through: i) participation in the commercial market with investment funds that award mandates to private investments specialists; ii) direct public financing to SMEs under programmes managed by public financial institutions; iii) guarantees to private institutions that offer SMEs the financial facility and; iv) funding of private investment companies at highly attractive terms.

2.5 Equity finance

Equity finance is key for companies that seek long-term corporate investment. It is especially relevant for firms that have a high risk-return profile, such as new, innovative and high-growth firms. Private equity, such as business angel investing and venture capital, can boost firm creation and development,
whereas public equity instruments, such as specialised platforms for SME public listing, can provide financial resources for growth-oriented SMEs.

Across OECD and non-OECD countries, private equity investments have developed substantially over the last two decades. This has partly offset the stagnation in public markets, although, following the global financial crisis, exit options have become more challenging for private equity investors.

2.5.1 Private equity: business angel investing and venture capital

Private equity financing includes a broad range of external financing instruments, whereby the enterprise obtains funds from private sources in exchange for an ownership stake of the firm (see Table 3). The capital is provided to private companies, i.e. companies whose shares are not freely tradable in any public stock market, across the entire life cycle, from seed financing to buyouts. Through private equity, wealthy individuals, investment funds or institutions participate fully in the entrepreneurial risk of the business, as capital is made available without provision of security. The objective of investors is to make profit by “exiting” (i.e. selling their shares through an IPO, a trade sale or buyback by the other shareholders) once the firm has increased its share value.

Private equity companies typically focus on high growth potential or under-performing companies that can be transformed and subsequently sold or floated, fostering rapid corporate restructuring. To do so, they generally operate with better information and stronger controls and influence over management than funds holding quoted equities. Also, private equity investments are less volatile than those in the stock market. Trading does not have an impact on the asset class, as assets are held until maturity and valued on the basis of corporate fundamentals rather than depending on market fluctuations. The lower sensitivity to market variations provides investors a form of protection against equity market downturn and enables them to have stable and attractive returns. Furthermore, private equity financing can help high-growth firms access public equity markets at a later stage; by going through rounds of private equity raising, firms can develop more structured governance and management systems, as well as enhance their products or services.
### Table 3. Private equity by stage

<table>
<thead>
<tr>
<th>Stages</th>
<th>Definition*</th>
</tr>
</thead>
<tbody>
<tr>
<td>Pre-seed/Seed</td>
<td>Financing provided to research, assess and develop an initial concept before a business has reached the start-up phase</td>
</tr>
<tr>
<td>Start-up/ Other early stage</td>
<td>Financing for product development and initial marketing. Companies have not sold their product commercially and are in the process of being set up.</td>
</tr>
<tr>
<td>Later stage venture</td>
<td>Financing for the expansion of an operating company.</td>
</tr>
<tr>
<td>Growth</td>
<td>Investment in relatively mature companies that are looking for capital to expand into new markets or restructure operations.</td>
</tr>
<tr>
<td>Buyout</td>
<td>Financing to acquire a company. It may use a significant amount of borrowed money to meet the cost of acquisition.</td>
</tr>
<tr>
<td>Replacement</td>
<td>The purchase of a minority stake of existing shares in a company from another private equity firm or from another shareholder or shareholders.</td>
</tr>
<tr>
<td>Rescue/Turnaround</td>
<td>Financing made available to an existing business in difficulty, with a view to re-establishing prosperity.</td>
</tr>
</tbody>
</table>


Across economies, private equity investments have developed substantially over the last two decades. This has partly offset the stagnation in public markets, although, following the global financial crisis, exit options have become more challenging for private equity investors. In particular venture capital and business angel investing have been providing new financing opportunities for innovative, high growth potential start-ups, mainly, though not exclusively, in high-tech fields. Venture capital and angel investors are characterised by different motivations, targets, scale and operating models, but are highly complementary in the financing continuum for early stage firms. Business angels need a well-functioning Venture Capital (VC) market to provide the follow-on finance that some of the businesses they support will require. At the same time, a well-developed angel market can create more investment opportunities and increase the deal flows for VCs. In other terms, interconnectedness across segments of the financial markets and investors is key for mobilising financial resources towards innovative and growth-oriented ventures.

#### 2.5.2 SME equity listings

Public listings of SME equity through primary and secondary issuance has the potential to provide funding for a company’s growth and can support subsequent debt financing. Indeed, public equity markets have to be regarded as complementary, rather than competitive, to bank financing.

Equity markets are to a large extent tapped by fast-growing, innovative, young companies. Existing SME owners can realise their capital gains and tap a wider investor universe, including retail investors and sophisticated long-term institutional investors. Typically, the benefits of public equity offerings for SMEs extend beyond initial access to capital (IPO) to longer-term repeat access to financing (secondary/follow-on raisings). Furthermore, SMEs that issue public equity enjoy a number of other benefits, related to increased creditworthiness, transparency, visibility and credibility by association with a dedicated ecosystem and an advisory community. Also, public accountability, increased transparency and reporting that are implicitly or explicitly required by the markets encourage better management practices,
governance and performance monitoring. The investor base of a company is extended and, at the same time, risks tend to be distributed more efficiently. SME owners can realise their capital gains while enhancing the capital structure of their company and manage their cost of capital.

For decades, private market participants and officials have been seeking to encourage the development of specialised exchanges or similar trading platforms to address some of the SME structural disadvantages in accessing public markets and satisfy their demand for equity finance. Typically, “SME growth markets” offer more flexible listing criteria, eased disclosure requirements and comparatively low admission costs, as to cater to SMEs’ inherent characteristics.

However, due to their inherent characteristics, only a relatively small number of SMEs are suitable for accessing public markets. SMEs often lack transparent and standardised information, financial sophistication and reporting capabilities, communications efforts and visibility. Cultural factors and management practices also constitute challenges for SMEs. Lack of confidence to go through the offering process, fear of being exposed to share price volatility, aversion to sharing sensitive information, but also lack of education around the process of listing and life after an IPO are other reasons for SME reluctance to join equity capital markets. In addition, entrepreneurs tend to be unwilling to relinquish ownership or control of their business or accept potential lock-in periods upon listing.

On the investor side of the market, financiers are confronted with high monitoring costs relative to the level of investment, regulatory obstacles and investor protection considerations. Low levels of liquidity in SME growth markets (inherent in the SME asset class) act as one of the main deterrents to investment in public SME equity.

Policy has sought to mobilise retail investment to address the lack of liquidity in SME equity markets, for instance by increasing the threshold level at which public disclosure and related requirements kick in, or by providing tax breaks for investment in unquoted companies which may subsequently list. Recent regulatory approaches recognise that these platforms may require tailored regulation and infrastructure, to facilitate access by SMEs while preserving investor interest. In some countries, new markets offer growth-oriented entrepreneurs dedicated services, such as the introduction to experienced investors, or the possibility to retain a higher level ownership than a traditional IPO.

3. Conclusions and guidance

Strengthening SME access to bank finance and broadening the range of financing instruments available to SMEs are essential to ensure they fulfil their role in growth, job creation and innovation. However, a number of challenges persist that limit lending to SMEs as well as their uptake of non-bank finance instruments, including asset based finance, crowdfunding, hybrid tools and equity instruments, most of which are currently at the reach of only a small share of SMEs.

The G20/OECD High-Level Principles on SME Financing provide a coherent framework to support governments in the development of cross-cutting policy strategies to enhance SME access to finance, calling for a sound regulatory approach and policy mix, which take into account constraints on both the supply and demand-side of SME financing markets, and relies on a strong evidence base on diverse SME financing needs and gaps (Table 4). The principles are voluntary and non-binding, and build on existing international financial principles and guidelines.

The development of Effective Approaches for the implementation of the G20/OECD High-Level Principles on SME Financing will support governments in identifying and designing appropriate policy measures to address the key challenges for broadening the range of financing instruments available to SMEs, in particular for equity markets.
Table 4. G20/OECD High-level Principles on SME Financing

1. Identify SME financing needs and gaps and improve the evidence base.
2. Strengthen SME access to traditional bank financing.
3. Enable SMEs to access diverse non-traditional bank financing instruments and channels.
4. Promote financial inclusion for SMEs and ease access to formal financial services, including for informal firms.
5. Design regulation that supports a range of financing instruments for SMEs, while ensuring financial stability and investor protection.
6. Improve transparency in SME finance markets.
7. Enhance SME financial skills and strategic vision.
8. Adopt principles of risk sharing for publicly supported SME finance instruments.
9. Encourage timely payments in commercial transactions and public procurement.
10. Design public programmes for SME finance which ensure additionality, cost effectiveness and user-friendliness.

In traditional debt markets, mechanisms for sharing and mitigating the risk inherent in SME lending, such as, among others, credit guarantees, trade receivables, securitisation and credit insurance, can improve bank capacity and incentives to lend to SMEs with affordable and diverse credit products. Furthermore, bank resilience should be reinforced, such as through adequate provision for loan losses and better capital positions.

The opacity of SME finance markets represents an important deterrent for investors, particularly in the riskier segment of the market. Information infrastructures for credit risk assessment, such as credit bureaux or registries or data warehouses with loan-level granularity, can provide a more accurate picture of the riskiness of SME finance and help investors identify opportunities. To this aim, the standardisation of credit risk information should be pursued, its broader accessibility facilitated and the development of specific SME credit-risk management skills supported. More reliable information about risk may also help reduce the cost of financing, which is typically higher for SMEs than for large firms. In this regard, the emergence of new mechanisms for assessing and mitigating risk holds particular promise. Furthermore, to address under-collateralisation, which typically limits SMEs access to bank finance, policy makers should consider enabling SMEs to use a broader set of assets beyond fixed collateral, such as movable assets, to secure loans.
**Recommendations**

- Improve bank capacity and incentives to lend to SMEs with affordable and diverse credit products, including among others through credit guarantees, trade receivables, securitisation and credit insurance and by reinforcing bank resilience (adequate provision for loan losses and better capital positions). Consider enabling SMEs to use a broader set of assets beyond fixed collateral, such as movable assets.

- Support multiple and competing sources of finance for SMEs, including asset based finance (e.g. factoring, leasing, asset-based lending), alternative forms of debt (e.g. corporate bonds, private placements, debt funds), crowdfunding, hybrid tools (e.g. subordinated loans, mezzanine finance) and equity instruments with special consideration for venture capital and private equity financing, including business angels.

- Enhance the information infrastructure for credit risk assessment, including through providing the conditions for the development of credit bureaus, credit rating agencies and data warehouses with loan-level granularity, the standardisation of credit risk information and its broader accessibility and support the development of specific SME credit risk management skills.

To sustain the development of alternative financing instruments, demand- and supply-side impediments should be addressed in tandem. On the demand side, many entrepreneurs and business owners lack financial knowledge, strategic vision, resources and sometimes even the willingness or awareness to successfully attract sources of finance other than straight debt. The lack of appetite by SMEs or alternative financial instruments, equity in particular, can also in parts be attributed to their tax treatment vis-à-vis straight debt. On the supply side, potential investors are sometimes hesitant to enter due to the overall opacity of the SME finance market, with large information asymmetries and a scarcity of transparent credit data, a lack of exit options, as well as persisting regulatory impediments. As a consequence of these obstacles, financial instruments for SMEs often operate in thin, illiquid markets, with a low number of market participants, which, in turn drives down demand from SMEs and discourages potential suppliers of finance.

The regulatory framework is a key enabler for the development of instruments that imply a greater risk for investors than traditional debt finance. This is even more the case in the face of a rapidly evolving market, where new financing models and risk mitigation measures are emerging. Effective and predictable insolvency regimes are needed to ensure creditor rights while supporting healthy companies and offering a second chance for honest entrepreneurs. To promote a level playing field for debt and non-debt financing instruments, it is necessary to address legal, regulatory and taxation biases that may place alternative instruments at a disadvantage with respect to traditional debt. The standardisation of regulation and documentation, as well as the diffusion of best practices, can help to promote the development of new markets and instruments (e.g. private placements). Furthermore, governments increasingly recognise the importance of addressing the fragmentation financial markets, by removing barriers to cross-border investment, to help SMEs tap into more diverse sources of capital and lower their costs of funding, as well as to broaden opportunities for investors and savers (e.g. European Commission’s Capital Markets Union Action Plan, ASEAN Economic Blueprint 2025).

In the case of SME public equity markets, the right balance between administrative and regulatory burden and due diligence needs to be achieved, so that the flexibility provided to SMEs does not compromise investor protection, integrity of market participants, corporate governance or transparency. In this regard, a regulatory and supervisory approach that facilitates access to public equity for SMEs, without compromising financial stability and investor protection should be promoted. The application of proportionate requirements for smaller equity issuers would translate into different, but not necessarily
lower, requirements, and in some cases these would even have to be higher for small caps as compared to large caps.

**Recommendations**

- Promote effective and predictable insolvency regimes, to ensure creditor rights and strengthen the confidence of a broad range of investors in SME markets.

- Promote a level playing field for debt and non-debt financing instruments, by addressing legal, regulatory and taxation biases that may place alternative instruments at a disadvantage with respect to traditional debt.

- Foster standardisation of regulation and documentation, and diffusion of best practices in order to promote the development of new markets and instruments (e.g. private placements).

- Promote a regulatory and supervisory approach that facilitates access to public equity for SMEs, without compromising financial stability and investor protection. Facilitate the participation in SME equity markets by retail and institutional investors, including by enhancing the development of risk mitigation instruments and by promoting the development of asset management vehicles or funds.

Policymakers can play a role in the development of a conducive ecosystem for SMEs in public and private equity markets and non-debt financial instruments and in favouring market liquidity, by supporting the development of SME advisory and research services; incentivising market participants in a way that discourages short-termism and competition based on price of trade execution; facilitating standardisation and homogenisation; fostering connectivity between investors and across investment segments, reducing disparities that create arbitrage opportunities (e.g. differential tax treatment); and fostering adequate instruments for retail investment.

Furthermore, public programmes can be used to leverage private resources and competencies and develop appropriate risk-sharing and mitigating mechanisms, such as through co-investment or guarantee schemes and private-public equity funds. Governments can contribute to raise awareness and improve knowledge by different financial providers about investment opportunities in SMEs, by raising the profile of the public debate about SME finance market development and investors’ advantages from diversification in the SME asset class; by improving visibility of successful transactions and platforms for alternative instruments; and by facilitating information sharing between investors and SMEs. Support is especially needed to strengthen the financing of start-ups and innovative SMEs, which typically lack both the credit history and the collateral needed to mitigate a high risk profile, including, where appropriate, through regulatory approaches and fiscal incentives to retail and institutional investors.

**Recommendations**

- Taking into consideration the firm’s profile, support the development of specific ecosystems for SMEs in (public and private) equity markets and non-debt financial instruments and foster market liquidity; support the development of SME advisory and research services as well as a reduction of disparities that create arbitrage opportunities (e.g. differential tax treatment). An emphasis on standardisation and homogenisation, when possible and relevant, would be useful.

- Raise awareness and improve knowledge by diverse financial providers about investment opportunities in SMEs, by raising the profile of the public debate about SME finance market
development and investors’ advantages from diversification in the SME asset class, by improving visibility of successful transactions and platforms for alternative instruments and by facilitating information sharing between investors and SMEs.

- Foster connectivity between investors in (public and private) equity markets for SMEs and across investment segments, such as by facilitating information sharing and co-investment to enhance information flows and transparency, to increase market liquidity and to improve exit options for investors.

- Support financing of start-up and innovative SMEs (that lack both the credit history and the collateral needed to mitigate a typically high risk profile), including, where appropriate, through regulatory approaches and fiscal incentives to retail and institutional investors.

Use public programmes to leverage private resources and competencies and develop appropriate risk-sharing and mitigating mechanisms, for example through co-investment/guarantee schemes and private-public equity funds, in order to enhance the resilience of SME financing.

Financial literacy is a powerful tool to enhance SMEs’ capacity to identify and access financing instruments that are most suited to their needs. Targeted financial education programmes can help entrepreneurs to address specific challenges, such as disentangling their personal and business finances, keeping records, using financial statements and financial ratios, identifying and approaching providers of finance and investors, managing financial risk, as well as understanding the economic and financial landscape of relevance to their business. Complementing financial support for SMEs with non-financial elements, such as counselling and mentoring, can enhance SME financial skills and planning. In this regard, the providers of SME-targeted programmes, including governments, MDBs and relevant non-for-profit institutions, can play a key role to foster SME financial capabilities. In particular, MDBs can provide an important contribution in promoting financial literacy, especially in emerging economies and developing countries, by matching their lending activity with advisory services and by developing country analysis and diagnostics, which can help guide efforts to strengthen financial literacy frameworks.

Investor-readiness programmes can help SMEs understand and meet the requirements of external investors and, more broadly, raise the quality of investment opportunities. The creation of networks linking entrepreneurs with investors can also help to improve knowledge exchange about SMEs’ and investors’ needs and requirements. In this regard, matchmaking services which are complemented by additional support and mentoring services, both for SMEs and potential investors, can be particularly effective. Public authorities should be involved as appropriate, including supervisors, with the intent enhance understanding of and awareness of the financing needs of SMEs and objectives of investors investing in such firms. The creation of links between investors, entrepreneurs and larger companies can also contribute to increase successful exits of investments.

The corporate governance of SMEs can play a role to enhance their investor-readiness. The G20/OECD Principles of Corporate Governance can provide guidance in a number of important areas, such as the rights of shareholders, institutional investor practices, the functioning of stock markets, the role of stakeholders, corporate disclosure, the responsibilities of the board of directors, as well as the quality of regulatory supervision and enforcement.
**Recommendations**

- Enhance the financial skills of SME management, by raising awareness and understanding about the risks and opportunities offered by different financing instruments, legislation and programmes for SMEs, and by developing advisory services to improve accounting and financial management.

- Improve the overall quality of investment and entrepreneurial projects, including through investor-readiness programmes that enhance SMEs’ ability to approach different types of investors and meet their information requirements.

- Improve SME linkages with the investor community by encouraging formal and informal networks that link entrepreneurs with investors and larger companies, and by supporting matchmaking services, involving public authorities as appropriate, including supervisors, with the intent to get a better understanding and awareness of the financing needs of SMEs and objectives of investors investing in such firms.

In spite of the growing importance of alternative financing tools for financiers and SMEs, the evidence base remains patchy in most countries. The lack of hard data on non-debt financing instruments represents an important limitation for the design, implementation and assessment of policies in this area. This limitation is particularly critical when seeking to take account of SME heterogeneity in the process of policy design. Micro data and micro-level analysis are essential to improve understanding about the different needs of the SMEs sector and may help to better understand the potential and challenges of new business models emerging in the financial sector, including fintech and crowdfunding platforms.

Governments should place efforts on improving statistical information on SMEs’ access to diverse sources of financing, in order to assess the extent to which their financing needs for long-term investment and growth are met and where capital gaps exist. This calls for cooperation among stakeholders, including central banks and financial supervisory authorities, national and multilateral development banks, financial and research institutions and SME representatives. It also calls for cooperation at the international level, to facilitate international benchmarking and regulatory coordination, and shed light on outstanding financing gaps and issues.

**Recommendation**

- Improve understanding of the diverse financing needs of SMEs and statistical information on SME financing, through collection of statistical data on SME access to bank and non-bank finance, micro data and micro-level analysis, SME surveys and regular consultations with stakeholders (both financial and non-financial).
REFERENCES


