SME and Entrepreneurship Financing
Tools and Measures

Capacity Building Seminar
Implementing SME Policy Tools
Trento, 27 October 2011

Lucia Cusmano
Senior Economist
Secretary to OECD Working Party on SMEs and Entrepreneurship (WPSMEE)
OECD Centre for SMEs, Entrepreneurship & Local Development (CFE)
SME Financing Gap

SMEs account for

- 98% of enterprises, 60% of employment in OECD countries
- 45% of employment, 30% of GDP in developing economies

(not including the large informal sector)

But receive a minor share of financing

- 10%-30% of bank loans across OECD countries
- 65%-70% of SMEs in developing countries lack access to credit
The impact of the global crisis

Two shocks that adversely affected SME cash flows:

1) a drastic drop in final demand for goods and services
2) a deterioration of credit conditions: credit crunch

- Greater risk aversion by financial institutions
- SME creditworthiness deteriorated. Decline in
  - Economic prospect
  - Balance sheet quality
  - Real estate (price levels and uncertainty)

- Long-standing, structural problems in financing new/innovative companies
Credit demand side

SMEs reacted by:

a) Conserving liquidity through reducing operating costs running down inventories cutting investment including innovation spending
b) Reducing use of external finance
c) Changing the composition of credit demand
   - Less investment finance
   - More working capital and export finance
Key trends

• **SME loans shares** in business lending generally **declined:**
  - supply component: **rejection rates** increased
  - demand components (“discouraged borrowers”)

• SMEs faced more severe credit conditions than large firms
  - interest rate **spreads increased**
  - **Shortened maturities**
  - Increased request for collateral

• Other sources of funding declined
  - **Venture capital** invested **declined**
  - **Payment delays** increased
Total and SME business loans, 2007-09
Quarterly, in EUR millions and as a % of total business loans

Business loans, large firms
Business loans, SMEs
% of business loans, SMEs
Interest rate and spreads, 2007-09
Quarterly, average SME interest rate and spreads between SMEs and large firm rates

Interest rate spreads (SME vs large firm)
SME average interest rate

<table>
<thead>
<tr>
<th>Quarter</th>
<th>2007</th>
<th>2008</th>
<th>2009</th>
</tr>
</thead>
<tbody>
<tr>
<td>Q1</td>
<td>0.77</td>
<td>1.39</td>
<td>1.45</td>
</tr>
<tr>
<td>Q2</td>
<td>0.95</td>
<td>1.45</td>
<td>1.31</td>
</tr>
<tr>
<td>Q3</td>
<td>1.07</td>
<td>1.35</td>
<td>1.32</td>
</tr>
<tr>
<td>Q4</td>
<td>0.80</td>
<td>0.94</td>
<td>1.04</td>
</tr>
<tr>
<td>Q1</td>
<td>0.80</td>
<td>1.39</td>
<td>1.31</td>
</tr>
<tr>
<td>Q2</td>
<td>0.94</td>
<td>1.45</td>
<td>1.35</td>
</tr>
<tr>
<td>Q3</td>
<td>1.04</td>
<td>1.31</td>
<td>1.32</td>
</tr>
<tr>
<td>Q4</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
Government responses to improve SME access to finance

*Easing cash flow*
- Increased direct lending
- Rolling over SME loans
- Loan guarantees
  - New, extended coverage, postponed repayment
- Combining guaranteed loans with advice services for start-ups (get started loans)
- Deferring or exempting tax payments temporarily
- Capping interest rates
- Credit mediation

*Favouring long term investment and balance sheet restructuring*
- Guarantees and tax incentives for equity capital
- Co-financing venture capital
Direct Loans and Loan Guarantees

- Official loan guarantees and direct official loans were the most widely used policy measures to increase access to finance
  
  - New or expanded programmes
  
  - Change in nature:
    - Before the crisis mainly concentrated on long term investment credits
    - Following liquidity shortages, government increasingly supported working capital
Loan Guarantees

Boost of the **leverage factor** of private and public guarantee schemes by:

- raising the total **counter-guarantee**:  
  ✓ Increased volume, coverage rate or sectoral coverage  
  ✓ Creation of new counter-guarantee funds

- increasing the **coverage rate**:

  Increased share of the loan risk that can be covered by guarantees (e.g. in France and Germany from 50%-60% to 90%)
Utilisation of Assistance Programmes

• Heavy take-up of official programmes, especially for Working Capital and Trade Finance

• Largest users of Official Guarantees & Direct Loans
  ✓ Medium-Sized Firms
  ✓ Manufacturing Firms
  ✓ Export-Oriented Firms

• Some Programmes heavily used by Smaller firms
  ✓ Mutual Guarantee Societies (MGS)
  ✓ Credit Mediation
Mutual Guarantee Societies (MGS)

• Purely mutual schemes:
  Beneficiary SMEs are shareholders and provide own fund via cooperative shares. The entrepreneurs manage the scheme themselves.

• Private schemes:
  Shareholders and providers of own funds are SME organisations, chambers of commerce, banking networks.

→ operate mid-way between SMEs, financial organisations, public authorities.
Added Value of MGS (1)

- SMEs:
  - “Cultural” proximity (language and business environment)
  - Recognition of qualitative factors in risk assessment (in-depth knowledge of sector, market, technology, etc)
  - Management support services and business plan analysis by third parties
  - Intermediary function (“credit mediation”)
  - Non-profit orientation
Added Value of MGS (2)

• Banks:
  ✓ Specific sectoral knowledge of SME customer
  ✓ Detailed financial file (vs. use of simple and standard methods)
  ✓ Use of more qualitative criteria in the credit application, which *completes* the more financially-oriented analysis of the bank loan.
  ✓ Financial supervision and support to SMEs
• Pan-European Grouping of 34 MGSs or federations of MGSs in 18 countries

More than 2 million SMEs beneficiaries

Source: European Association of Mutual Guarantee Societies (AECM), March 2010.
Introduced in several countries (e.g. France, Belgium, Ireland, Germany, Spain) to address the problem of information asymmetry, one of the major sources of conflict in the credit process, but also provide support in managing the credit relation:

**Conflicts in the credit process**

- Insufficient clarity and detail in the communication by the entrepreneur
- Inconsistencies in the proposed business plan, requiring adjustments
- Difficulties in meeting existing obligations due to temporarily shocks
- Request for guarantees
- Insufficient authority of the local bank, despite positive assessment of the business plan (decision made at a higher echelon)
Credit Mediation (2)

• Objective:

Improve information flows and use moral suasion (i.e. informal pressure or influence from authorities such as central banks) to encourage agreement between prospective lenders and SMEs.

• Mechanism:

Firms whose credit applications are rejected bring their case before a mediation panel (usually organised by the central bank) in which the SME, the bank and other interested parties (i.e. industry associations) participate.

• Advantages

✓ remedy to information asymmetry
✓ low cost (through existing institutions)
The process of Credit Mediation

• Credit request rejected
• Possibly appeal to the bank and confirmed rejection
• Firm’s call to the Credit mediator: submission of relevant information
• Assessment by the Credit Mediator and decision to proceed with the mediation process
  • Integration and revision of information by the firm
  • Facilitation of dialogue between the parties
  • Engagement of local or sectoral expertise
  • Access to guarantees or other support instruments

⇒ No authority to impose decision
⇒ Facilitation, “moral suasion”, learning and improvement by SME
Credit mediation in France

(Since 2008)
• Network of 105 local mediators, departmental directors of the **Banque de France**
• Role of the Prefect, chairing a monitoring unit
• Support by OSEO, participating and providing guarantees
• Support by professional networks, providing expertise and contextual knowledge

**November 2008 – June 2011:**
• The rate of successful mediation was 63%.
• The credit mediation scheme has reinforced about 15 000 firms of all sizes; unblocked EUR 3.5 billion in credit
Challenges ahead

• Governments fiscal consolidation
  – Phasing out of support measures
  – Need to mobilise private capitals

• SME capital structure: excessive reliance on debt
  – Favour equity investments
  – Broaden the funding options
    Venture capital, business angels, hybrid instruments

• Monitoring and evaluating
Equity

<table>
<thead>
<tr>
<th>Seed</th>
<th>Early stages</th>
<th>Expansion</th>
</tr>
</thead>
</table>

- **Venture capital and growth capital**
  - E.g. Tax-based VC schemes: providing investors’ income, capital gains and firm-level tax reliefs
  - E.g. Tax advantages to employee share schemes to raise equity and retain staff needed to grow

- **Business Angels**
  - Funding more relevant than VC
  - Filling the gap in early stages
  - E.g. Tax incentives, co-investment funds, support to angel associations and networks
Since the onset of the crisis, the assessment of its impact on SMEs and Entrepreneurs revealed that policy makers and major stakeholders (e.g. financial institutions) lack the **hard data** necessary to:

- **Monitor** SME financing trends and needs
- **Evaluate** SME financing policies and programmes
OECD Scoreboard on SME and Entrepreneurship Finance

Framework to monitor trends and support formulation and evaluation of policies

<table>
<thead>
<tr>
<th>DEBT</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>SME loans / business loans</td>
<td>SME non-performing loans/SME loans</td>
</tr>
<tr>
<td>SME short term loans/SME loans</td>
<td>SME interest rates</td>
</tr>
<tr>
<td>SME gov. guaranteed loans/SME loans</td>
<td>Interest rate spreads (small vs. large firms)</td>
</tr>
<tr>
<td>SME gov. direct loans/SME loans</td>
<td>SME collateral</td>
</tr>
<tr>
<td>SME loans authorized/SME loans requested</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>EQUITY</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Venture capital and growth capital</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>OTHER</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>SME payment delays</td>
<td></td>
</tr>
<tr>
<td>SME bankruptcies</td>
<td></td>
</tr>
</tbody>
</table>
OECD WPSMEE Recommendations to improve data collection and monitoring

• Require financial institutions
  – to use the national definition for an SME, based on firm size
  – to report on a timely basis to their regulatory authorities SME loans, interest rates, collateral requirements, as well as those loans that have government support

• Encourage international, regional and national authorities as well as business associations to work together to harmonise quantitative demand-side surveys

• Promote the harmonisation of the definition of Venture Capital