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'BOLOGNA+10' HIGH-LEVEL MEETING

ON

LESSONS FROM THE GLOBAL CRISIS AND THE WAY FORWARD TO JOB CREATION AND GROWTH

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Issues Paper 2: Better Financing for SMEs and Entrepreneurs for Job Creation and Growth

Centre for Entrepreneurship, SMEs and Local Development

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MINISTÈRE DE L'ÉCONOMIE DE L'INDUSTRIE ET DE L'EMPLOI

OECD WPSMEE "BOLOGNA +10" HIGH-LEVEL MEETING ON

"*SMEs and Entrepreneurship: Lessons from the Global Crisis and the Way Forward to Job Creation and Growth*"

SESSION 2

Better Financing for SMEs and Entrepreneurs for Job Creation and Growth

ISSUES PAPER

The crisis is nearing its end, but a difficult period of restructuring lies ahead…

1. The global crisis, narrowly defined, appears to be drawing to a close. Following the sharp declines in real GDP of 2009 growth in OECD countries is now positive, with a slight acceleration forecast for 2011 and financial institutions no longer face the immediate risk of insolvency. Nevertheless, the present situation in economic and financial markets can hardly be characterised as normal as central banks still feel obliged to hold interest rates at historically low levels. In line with the return to positive growth, SMEs are experiencing a modest recovery in 2010, with further gains likely next year. Nevertheless, it would be a serious mistake to expect a resumption of "business as usual." All signs point to a very challenging environment for SME and entrepreneurship finance in the years ahead.

…while SMEs are still struggling with the effects of the crisis

2. Despite the recovery of aggregate output, there are indications in a number of countries that SMEs have not emerged from the crisis in as strong a condition as larger companies. The crisis had a strongly negative impact on SME output, sales, employment and exports in 2008-2009. While SMEs are generally recovering, in certain sectors (*e.g.* construction and real estate) small firms continued to experience contraction through 2010. The balance sheets of many SMEs worsened in 2010 reflecting the poor results of 2008-09. The number of insolvencies, which remains considerably above its historic average, is still rising in some countries. Thus, while the Euler Hermes index of insolvencies for the United States peaked in 2009 the index for the Euro area is only expected to peak in 2010.[1]

Unemployment has risen significantly

3. The number of unemployed in OECD countries has risen about 50%, and many OECD countries now face the challenge of replacing those jobs lost during the crisis as well as the challenge of creating new jobs for the future. Job creation has special relevance for SMEs, which account for a large share of employment - and net job creation - in most countries. In previous downturns SMEs were less likely than larger companies to shed labour, but in several countries where the deterioration in labour market conditions was severe in 2008-09, SMEs have been shedding workers at least as rapidly as larger firms. Countries where the rise in unemployment was noticeably higher than average include Ireland, Spain, Denmark, New Zealand, Iceland, and the United States.

[1] Euler Hermes is a provider of credit insurance that produces analyses of the financial positions of companies in major markets. Press Release Paris, 28 June 2010. "Global economic recovery is already under pressure; corporate insolvencies set to continue at high levels until 2011."

SMEs and entrepreneurs suffered deterioration in their access to finance

4. SMEs have been noticeably slower in regaining access to credit markets than larger companies. During 2008-09, companies of all sizes faced severe liquidity tightness as credit markets froze. Between 2008 and 2009 bank credit to SMEs either increased by very small amounts or in some cases showed an actual decline. In 2010, credit has generally remained flat but in a few cases it has begun to expand gradually, with wide dispersion among sectors and companies.

5. SMEs faced a hardening of credit terms in 2008-09. Banks imposed higher margins, higher fees, stricter collateral requirements and tighter loan covenants while shortening maturities. In some cases, an easing of lending terms is discernible in 2010 but in others lending conditions remain difficult, particularly for small companies. This slow and hesitant return to credit markets by SMEs can be contrasted with the situation of larger companies, which have generally built up strong cash positions, positions that enable large firms not only to borrow from banks on favourable terms but to return to the capital markets on a substantial scale.

The financial system has achieved some stabilisation

6. Owing to massive official support, the financial system has achieved a modicum of stability. Banks initially reacted to market turbulence by squeezing credit, including credit to SMEs. By 2010, most banks that survived the crisis have achieved positive earnings and no longer face imminent insolvency. In the post-crisis environment banks will be seeking to develop business models that generate long-term stable growth of profits. Past experience suggests that SME lending has the potential to be a profitable line of business for financial institutions, provided that the proper enabling environment for SME finance is in place.

But, long-standing difficulties with SME access to finance persist…

7. While banks would like to develop SME finance, SMEs have always faced distinctive problems in obtaining resources due to the difficulties inherent in assessing SME risk and in achieving a productive alignment of risk and reward among borrowers, lenders and governments. Furthermore, the supervisory environment will be changing with the introduction of Basel III capital adequacy rules and other measures to limit banks' risk-taking activity. On balance, it is unclear whether the post-crisis regulatory environment will present additional obstacles for SMEs and entrepreneurs seeking financing.

…and the crisis has aggravated the financing problems of SMEs

8. Furthermore, some special vulnerabilities of SMEs finance that have been aggravated by the crisis are:

- The crisis has left many SMEs financially weakened as a result of lost revenues and a rise in short-term debt. Even with a recovery in overall lending many banks are hesitant about resuming lending and/or easing credit terms for small firms;

- The sharp drop in property prices has reduced the collateral value of real estate. This problem has been especially acute for small enterprises, where real estate is often used as collateral; and

- Funding for new and high-growth firms through business angels and venture capital has contracted sharply.

Emergency assistance programmes were generally effective

9. Perceiving a serious failure in SME credit markets in 2008-09, most OECD countries introduced or enhanced programmes to assure that SMEs would maintain access to finance. The main kinds of special anti-crisis measures were: a) official loan guarantees and direct public loans, b) export facilitation and c) credit mediation[2]. As of late 2010 most of the countries that have evaluated their programmes, have concluded that emergency support programmes were an appropriate policy response to the crisis.

Now, policies must be adapted to the post-crisis environment

10. Even though many SMEs are still struggling with the after-effects of the crisis, it is clearly appropriate now to reflect upon how governments should sequence the transition of policies as we approach the post-crisis environment. Most of the policies introduced in 2008-09 were launched to address the malfunctioning of credit markets in 2008-09 in which banks sought to reduce the size of their assets while avoiding risky assets. To a serious degree, the financial market had ceased performing its normal functioning of allocating resources by assessing, pricing and assuming risk. Most of the policies to address this market failure ultimately involved a transfer of credit risk from the markets to the official sector. Government guarantee programmes have entailed very high rates of guarantee - often providing coverage in excess of 80%. Most SME finance experts and bankers involved in SME finance would prefer mechanisms under which risk is distributed more evenly among SMEs, banks and public authorities.

A gradual withdrawal of crisis measures should now be considered

11. To the degree that current market conditions no longer justify emergency support measures it is time to begin phasing out those measures, while exercising due consideration for the specific situation of various sub-sectors of the markets. The work by the OECD Secretariat indicates that economic and financial conditions facing SMEs have generally improved but that serious imbalances persist in several sub-sectors. In particular in most countries smaller companies appear to be regaining access to markets at a slower pace than medium-sized companies. Accordingly, there is a case for phasing out measures that are heavily used by smaller enterprises on a slower timetable. At the same time, some measures that addressed special vulnerabilities of small enterprises, notably credit mediation, may prove relevant in the post-crisis environment.

Post-crisis policies should support structural transformation

12. In the coming period of structural adjustment, a substantially different set of policies will be needed. One would expect high levels of firm formation and a large numbers of exits. Instead of investment cutbacks to preserve liquidity one would expect growing outlays in firms in emerging sectors of the economy. Indeed, given the need in many countries to offset job losses from the recession, it will be necessary to finance sizeable net increases in investment. Financial markets will have to discriminate between firms deserving to receive credit and those that should be encouraged to contract or exit. Thus, policies to protect existing firms and existing jobs in those firms through transfer of risk will be less relevant in a more dynamic environment. Similarly, policies that enabled firms to take on more debt will be less relevant in environments where fast growing firms need more robust capital structures.

[2] Credit mediation is a technique introduced in France and Belgium in late 2008 or early 2009 (and subsequently introduced in Germany and Spain.) Under credit mediation, SMEs that have been rejected by banks can appeal to a mediation panel in which governments, business associations and banks are represented. The mediator seeks to improve communication and improving information flows between SMEs and banks. See *the Assessment of Government Support Programmes for SMEs and Entrepreneurs' Access to Finance in the Global Crisis: Final Synthesis Report* [CFE/SME(2009)14/REV3].

Alternatives to debt finance and to the heavy use of government guarantees should be explored

13. Countries will want to explore alternative financing mechanisms that produce socially productive incentives for firms, governments and providers of finance. At the same time new financing mechanisms will have to address the thorny issue of how the entities involved in the allocation of financial resources (governments, financial institutions, or MGSs) will determine which firms deserve to receive financing.

14. In the past, firms in many countries tended to have very thin capitalisation and relied heavily upon debt finance. Policies that encourage de-leveraging and strengthening of capital structures can be a contribution to the development of alternative funding techniques. For example, many countries have strengthened programmes to use guarantees in equity-related investments or other techniques (*e.g.* subordinated debt and convertible bonds) to enable SMEs to increase their capital. Government can provide support for the development of securities exchanges suited to the special characteristics of smaller companies. Additionally, governments can review their regulatory regime for institutional investors so as to be sure that rules do not inadvertently discourage investment in smaller companies. There is substantial scope for countries to experiment with new financing mechanisms and to share their relevant experience.

Newer, innovative and fast-growing companies continue to face serious obstacles in obtaining finance

15. It should be kept in mind that even before the onset of the crisis many countries faced considerable difficulties in providing finance to newer and innovative companies and to firms in technology-related fields. Such companies are often at the forefront of job creation, in the commercial applications of new technology, and in the development of new business models. Traditional banking techniques often have limited applicability to this kind of company. The crisis may have temporarily diverted attention from this long-standing problem, but it is certain to reappear in the post-crisis period, where it will be imperative to identify and finance promising companies. Moreover, some countries with previously strong records of net enterprise creation have experienced significant deterioration during the present recession.

16. High growth and innovative firms are characterised by unproved business models (often embodying new technology) that are difficult to evaluate using the traditional credit analysis tools of banking. Almost invariably, the firms will not be able to provide the collateral that banks typically use as a risk-sharing technique. Innovative firms usually have higher rates of failure than traditional firms, making them unsuitable for debt finance. In some countries mechanisms have been developed that enable market participants (firms, entrepreneurs, financial intermediaries and institutional investors) to devise new methods to provide capital to these firms using new techniques to allocate risk and reward. Among the techniques that have proven successful in some countries under some circumstances are business angels and venture capital.

17. Governments have introduced a wide range of policies to enlarge the access of innovative/high growth firms to finance. Relevant programmes include various combinations of grants, loans and equity participations. These programmes seek to provide private suppliers of finance with incentives to seek out promising companies while offering a risk/reward structure that encourages a high degree of participation by the private sector. There is considerable scope to experiment with new mechanisms and to share experience among policy makers, the research community and those active in SME finance.

SMEs in emerging markets have a long-standing problem in accessing formal finance.

18. Although much of the discussion in this note has centred on the problems of SMEs in OECD countries, the problems of SMEs access to finance in emerging markets warrant special consideration. On the one hand, the emerging markets have weathered the recent crisis better than OECD countries and are thus under less immediate pressure to introduce policy reforms. Emerging markets withstood the destabilizing trends in the global financial system partly because they had been less willing to allow financial innovation and adhered to conventional risk limitation policies. On the other hand, it has often been observed that banks in emerging markets frequently shun lending to smaller companies, which have therefore mainly relied on self-finance and informal markets. In the future, the authorities in emerging markets must strike a balance between continuing to impose strict risk control regulations while encouraging experimentation in financing of SMEs by local institutions.

Points for discussion

(i) What are the observations of delegates about the impact of the post-2007 crisis on SMEs in their respective countries and on the world economy? Are SMEs lagging the rest of the economy in rebounding from the crisis? To what extent have the deterioration of employment, the decline in property markets and the weakening of SME balance sheets complicated the prospects for SME finance?

(ii) Which kinds of anti-crisis measures should be phased out relatively quickly and which might have relevance for the post-crisis environment. In what way will the withdrawal of emergency support measures have to take account of lingering problems in certain sub-sectors of the SME sector?

(iii) What are the main challenges for SME finance in the post-crisis environment? In what ways will changes in the supervisory architecture affect SME financing?

(iv) How important is it to develop alternatives to traditional bank loans and official credit guarantees for SME finance and how can governments help in developing appropriate financial products.

(v) What can governments do to facilitate the financing of newer, fast growing and innovative companies?

(vi) How far have emerging markets progressed in their capability to enlarge SME access to finance? How can governments in emerging markets encourage financial institutions to increase financing of SMEs while maintaining high prudential standards?

Proposed Recommendations

Policies and Programmes

- The world economy is gradually emerging from the financial crisis and recession of 2008-09 into a period of economic restructuring and financial reform. Therefore, emergency policies to support SMEs access to finance that were introduced to address the unique market failures during the crisis should be reviewed in detail to determine whether such policies are still justified.
- As part of that review, programmes in which the state guarantees very high shares of loans need to be carefully re-considered.
- Inasmuch as smaller firms are regaining access to markets at a relatively slow pace, there is a credible case that emergency measures targeted to smaller firms should be withdrawn comparatively slowly.
- Due to the special needs of smaller enterprises, policy makers will want to consider whether certain policy instruments, notably credit mediation, that were first introduced in the crisis have a longer term relevance for SME finance.
- Inasmuch as many analysts have concluded that Mutual Guarantee Societies[3] (MGSs) have been effective in enlarging SME access to finance while promoting effective monitoring and risk sharing, policy makers may also want to analyse which policies would enable MGSs to play a more active role in the future*.*
- Governments should explore the possibilities to foster the development alternative financing techniques (*e.g.* equity, hybrid instruments and convertible debt) in order to enable SMEs to strengthen their capital structures.

Further Work by the OECD

- In view of expected post-crisis changes in the real economy and the financial landscape, the OECD should accelerate efforts to analyse and assess policies relevant to the financing of SMEs and entrepreneurs and to promote the sharing of best practices. The need to pursue this activity, which was recognised in "*the OECD Brasilia Action Statement for SME and Entrepreneurship Financing"* has taken on new urgency in view of the difficulties of SME finance that emerged during the recent crisis and the expected challenges of the post- crisis environment.
- The OECD should analyse the implications for SME finance of developments in the global structural and regulatory landscape for finance.
- A crucial aspect of work on enlarging SMEs' and entrepreneurs' access to finance is to analyse and share experience with respect to the institutional, legal, tax, regulatory and policy framework for SME finance. Analyses can cover issues such as direct loan and guarantee mechanisms as well as market infrastructure such as such as credit information systems and collateral registries. The scope for use of innovative financial instruments and private public partnerships should be explored.
- Analyses should consider both established SMEs in traditional sectors and fast growth technology-based SMEs.
- The process of evaluating policies introduced to address the crisis of 2008-10 should continue. The OECD can draw together and provide context for analyses by Member governments, industry associations and independent analysts. A valuable part of the analysis would be to evaluate the impact of emergency assistance programmes on the survival and later development of assisted firms. The "*OECD Framework for the Evaluation of SME and Entrepreneurship Policies and Programmes"* is a useful instrument for this analysis.
- The OECD should continue work on improvement, standardisation and dissemination of statistics on SME and entrepreneurship financing, particularly the *"OECD Scoreboard on SME and Entrepreneurship Financing Data and Policies".* Country coverage should be expanded with other OECD members and non-members encouraged to join the OECD Scoreboard project.
- The OECD should further strengthen its open tripartite dialogue involving governments, SMEs and the financial community to review and monitor progress in SME and entrepreneurship financing. This work could be carried out in close cooperation with other international organizations/institutions.

[3] Mutual Guarantee Societies (MGSs) are voluntary of small enterprises, usually in a specific geographic locality, in which the association jointly guarantees borrowings from banks by all members of the MGS.