



## Volume 1

# Access to Finance for SMEs: In Search of Innovative Solutions

Follow-up of the FEE Round Table Access to Finance for SMEs and the Economic Recovery - Challenges and Creative Solutions, Wednesday 13 October 2010, 10.00 - 16.00 hrs CEST, FEE Offices.

All presentations and a short video can be accessed at:

[http://www.fee.be/news/default.asp?library\\_ref=2&category\\_ref=214&content\\_ref=1285](http://www.fee.be/news/default.asp?library_ref=2&category_ref=214&content_ref=1285).

### **The dust has settled, but all is not well.**

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Two years after the collapse of Lehman Brothers, the European Central Bank's (ECB) research confirms that access to finance now trails both demand and competition as a concern for Europe's SMEs.<sup>1</sup> Only 15% of SMEs cite it as their number one concern, and for all their concerns small business organisations throughout Europe are no longer reporting a credit crunch.

While all of this is worth celebrating, the finance supply chain has not yet returned to normal. The gap between larger and smaller businesses' access to finance is widening, and SMEs' financing needs are growing faster. Smaller businesses are increasingly falling back on internal funds despite substantial loan approval rates; banks still generally see SMEs as riskier and thus require more information and collateral – in addition to levying higher fees.

Nor is this all just a matter of perceptions. The ECB's data show that SMEs are basing their perceptions on recent experience. On this basis, the ECB does not expect conditions to improve materially in the short term. This low-supply, low-demand equilibrium may not be as acute a problem as the disruption of late 2008, but it does nonetheless pose a genuine threat to the economic recovery in Europe, which SMEs report is already running out of steam.<sup>2</sup>

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<sup>1</sup> ECB (2010), *Survey on the Access to Finance of SMEs in the Euro Area – March to September 2010*, October 2010  
<http://www.ecb.int/pub/pdf/other/accesstofinancesmallmediumsizedenterprises201010en.pdf>

<sup>2</sup> UEAPME (2010), *EU Craft and SME Barometer H2/2010*  
[http://www.ueapme.com/IMG/pdf/101013\\_Barometer\\_2010H2\\_final.pdf](http://www.ueapme.com/IMG/pdf/101013_Barometer_2010H2_final.pdf)

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### Learning from mediation

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As evidence began to emerge in the past two years of a breakdown in communication between lenders and SMEs,<sup>3</sup> different forms of mediation services became available in many European countries, including Belgium, Germany, France, and Italy. The most celebrated of these, the French mediation scheme boasts an impressive 63% success rate<sup>4</sup> and is credited with improving access to finance by experts both in France and abroad.<sup>5</sup> Two important lessons can be drawn from the experience of formal credit mediation so far:

First, mediation works best in an environment of disclosure where objective evaluation is possible and universally trusted. The French mediator's high success rates are almost certainly linked to the fact that the Banque de France maintains rigorous credit ratings for a substantial share of the company population in that country. Importantly, banks are allowed by the state to use these in determining their capital requirements.<sup>6</sup>

Second, the true contribution of mediation may lie not in its effect on supply but in its ability to improve perceptions and limit the effects of discouraged demand. After all, despite receiving such wide acclaim the French mediation service has only assisted a very small number of rejected loan applicants in the past two years.<sup>7</sup>

Policymakers and the accounting profession also need to take note of these lessons, as lenders around the world confirm that accountants are *de facto* mediators between banks and small businesses.<sup>8</sup> A clear implication is that reporting and assurance to a widely accepted standard can make a difference to SMEs' access to finance. However, standards of reporting vary substantially among the member states, and are often driven by the demands of tax authorities rather than the information needs of creditors and other providers of finance. In light of this, the profession's role should be as much to educate the owners or managers of SMEs about the value of presenting accurate financial performance data as it is to liaise with lenders.

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<sup>3</sup> See for instance, ACCA, CGA-Canada and CPA Australia (2009) *Access to Finance for the Small and Medium Sized Enterprise Sector : Evidence and Conclusions* [http://www.accaglobal.com/documents/acca\\_cga\\_cpaa.pdf](http://www.accaglobal.com/documents/acca_cga_cpaa.pdf)

<sup>4</sup> 'Deux ans de Médiation du crédit aux entreprises: plus de 12,000 sociétés confortées dans leur activité, plus de 220,000 emplois préservés' MdC Press Notice, 14 October 2010

[http://www.mediateurducredit.fr/site/content/download/397/2368/file/CP\\_MDC141010.pdf](http://www.mediateurducredit.fr/site/content/download/397/2368/file/CP_MDC141010.pdf)

<sup>5</sup> See for instance, 'Business demands extension of EU crisis measures' Euractiv 4 October 2010

<http://www.euractiv.com/en/enterprise-jobs/business-demands-extension-eu-crisis-measures-news-498230>

<sup>6</sup> Steven, C. (2010) 'The Banque de France credit rating system: an asset for the Central Bank and a tool for commercial banks' *Banque de France Quarterly Selection of Articles v. 18, Summer 2010* [http://www.banque-france.fr/gb/publications/telechar/bulletin/qsqa/qsqa18/quarterly-selection-of-articles-summer-2010-18-etude\\_5.pdf](http://www.banque-france.fr/gb/publications/telechar/bulletin/qsqa/qsqa18/quarterly-selection-of-articles-summer-2010-18-etude_5.pdf)

<sup>7</sup> The ECB findings from H1 2009 to H1 2010 suggest that on average 27.3% of French SMEs had applied for a bank loan in the six months leading up to each survey and 9.8% were rejected. Extrapolating the average application and rejection rates for H2 2010 suggests a total of 256,000 failed applications in the two years of the mediator's operation, of which 12,470, or 4.9%, received mediation.

<sup>8</sup> *The Banker and International Federation of Accountants (IFAC) (2009), SME Lender Survey Frequency Report, 2009.* [web.ifac.org/download/thebanker-ifacsmelender-survey-full-results.doc](http://web.ifac.org/download/thebanker-ifacsmelender-survey-full-results.doc) The survey found that 59% of lenders said they were influenced to a significant extent by whether an external accountant has been involved in drawing up a loan application.

This obligation extends not only to accountants in practice but also to their colleagues in industry. With most of the remaining market imperfections focused on the supply of working capital, SMEs' in-house finance staff can provide insights to creditors that an external practitioner cannot.

## Building on guarantees

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Credit guarantee schemes for small businesses were a significant and successful element of the European response to the downturn of 2008-9.<sup>9</sup> Countries with a robust tradition of mutual guarantees have been able to avoid serious instances of market failure while those that are only now embracing this approach could see substantial benefits in the future as trust in the system is established.

As a permanent feature of the market for small business loans, well-designed systems of mutual guarantees are arguably superior to grants and subsidies for SMEs. They can leverage substantial funds (providing 5x to 10x leverage<sup>10</sup> at a low cost while achieving modest default rates, yielding substantial additionality and limiting market distortions.<sup>11</sup> A significant body of evidence already exists to guide policymakers. It suggests that more centralised schemes with a small number of lenders focusing on broad coverage and high volumes can be very successful, provided that procedures and responsibilities are clearly defined and proper co-operative relations are developed between lenders, guarantors and borrowers.<sup>12</sup>

## Warming to equity

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In the aftermath of the financial crisis of 2008 and the sovereign debt turmoil of 2010, Europe's economies are moving away from debt as a source of finance at all levels. The ECB data show that SMEs have led this shift by deleveraging substantially.<sup>13</sup> However, it is as true as ever that growing businesses need substantial amounts of finance and that not all of this can be sourced internally. As a result, policymakers' attention has correctly shifted to equity finance, and how access can be improved for SMEs.

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<sup>9</sup> UEAPME (2009) *National Recovery Plans from an SME Perspective*:

[http://www.ueapme.com/IMG/pdf/090213\\_BoD\\_recovery-plans.pdf](http://www.ueapme.com/IMG/pdf/090213_BoD_recovery-plans.pdf)

<sup>10</sup> Graham Bannock & Partners Ltd. (1997). *Credit Guarantee Schemes for Small Business Lending: A Global Perspective*. Unpublished report prepared for ODA, London

<sup>11</sup> Levitsky, J. (1997) 'Credit guarantee schemes for SMEs: an international review' *Small Enterprise Development* 8:2

[http://siteresources.worldbank.org/EXT/EXPCOMNET/Resources/2463593-1213887855468/04\\_Credit\\_guarantee\\_schemes\\_for\\_SMEs.pdf](http://siteresources.worldbank.org/EXT/EXPCOMNET/Resources/2463593-1213887855468/04_Credit_guarantee_schemes_for_SMEs.pdf)

<sup>12</sup> Levitsky, J. (1997) 'Credit guarantee schemes for SMEs: an international review' *Small Enterprise Development* 8:2

[http://siteresources.worldbank.org/EXT/EXPCOMNET/Resources/2463593-1213887855468/04\\_Credit\\_guarantee\\_schemes\\_for\\_SMEs.pdf](http://siteresources.worldbank.org/EXT/EXPCOMNET/Resources/2463593-1213887855468/04_Credit_guarantee_schemes_for_SMEs.pdf)

<sup>13</sup> ECB (2010), *Survey on the Access to Finance of SMEs in the Euro Area – March to September 2010*, October 2010  
<http://www.ecb.int/pub/pdf/other/accesstofinancesmallmediumsizedenterprises201010en.pdf>

Currently, only about 2% of SMEs use this option, despite the fact that three times as many (6%) cite it as their preferred choice. Only just over one third (37%) of Europe's SMEs would feel confident pitching to potential equity investors.<sup>14</sup> Moreover, equity investment is strongly cyclical and flows of funding have fallen substantially in the recession.<sup>15</sup>

Although external equity finance is only relevant to a small population of fast-growing businesses – perhaps 5%-10% of Europe's SMEs<sup>16</sup> – small amounts astutely invested can go a very long way, financing the rapid growth of Europe's most promising businesses. Yet there is a well-documented need for intervention in this market: the combination of high levels of risk and information asymmetry, as well as steep due diligence and compliance costs, results in a shortage of equity finance for businesses trying to raise less than €2m, which is only partly addressed by business angels and syndicates.<sup>17</sup> This is a substantial limitation as only 3% of those SMEs that would ideally like to use equity finance need more than €1m.<sup>18</sup>

Additional disincentives are provided by tax, which biases entrepreneurs in favour of debt finance, and of course by regulation. The Demarigny report,<sup>19</sup> for instance, demonstrated earlier this year that the regulatory framework is partly responsible for the fact that the European small listings market is in secular decline and provides only a trickle of liquidity to small issuers. We look forward to the Commission's Action Plan for improving SME access to the capital markets, announced in the Single Market Act<sup>20</sup> – the timing has rarely been better for a wholesale review of the regulations that most discourage small listings.

## Basel III – The devil is in the detail

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Basel III has not been designed for the small, community-based banks that provide much of the flow of credit to Europe's SMEs, and the crisis that prompted its creation was not the result of lending to small businesses.<sup>21</sup> As a result, Basel III has the potential to cause substantial collateral damage among SMEs and the decentralized structures (such as community banking) that have helped buttress the sector, while failing to address the problem of too-big-to-fail financial institutions.

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<sup>14</sup> Gallup (2010) *Access to Finance: Analytical Report*, Flash EB Series no. 271.

[http://ec.europa.eu/public\\_opinion/flash/fl\\_271\\_en.pdf](http://ec.europa.eu/public_opinion/flash/fl_271_en.pdf)

<sup>15</sup> Ruis, A., van Stel, A., Tsamis, A. Verhoeven, W. and Whittle, M. (2009), *Cyclicalities of SME Finance*

[http://ec.europa.eu/enterprise/newsroom/caf\\_getdocument.cfm?doc\\_id=3127](http://ec.europa.eu/enterprise/newsroom/caf_getdocument.cfm?doc_id=3127)

<sup>16</sup> Estimate based on Gallup (2010) *Access to Finance: Analytical Report*, Flash EB Series no. 271.

[http://ec.europa.eu/public\\_opinion/flash/fl\\_271\\_en.pdf](http://ec.europa.eu/public_opinion/flash/fl_271_en.pdf) The lower end of the range is equal to the percentage of EU SMEs identified as 'gazelles' (less than 5 years old, with 20%+ turnover growth over the last 3 years), while the higher is equal to the share of EU SMEs that were both innovators and were currently experiencing turnover growth of over 20% per annum

<sup>17</sup> OECD (2006), *The SME Finance Gap Vol. One – Theory and Evidence*

[http://ec.europa.eu/enterprise/newsroom/caf/document.cfm?action=display&doc\\_id=624&userservice\\_id=1](http://ec.europa.eu/enterprise/newsroom/caf/document.cfm?action=display&doc_id=624&userservice_id=1)

<sup>18</sup> Gallup (2010) *Access to Finance: Analytical Report*, Flash EB Series no. 271.

[http://ec.europa.eu/public\\_opinion/flash/fl\\_271\\_en.pdf](http://ec.europa.eu/public_opinion/flash/fl_271_en.pdf)

<sup>19</sup> Demarigny, F. (2010), *A Small Business Listing Act for Europe* – Establishing a proportionate regulatory and financial environment for Small and Medium-Sized Issuers Listed in Europe (SMILEs)

[www.eurocapitalmarkets.org/system/files/EU+Listing+SBA+EN+Final.pdf](http://www.eurocapitalmarkets.org/system/files/EU+Listing+SBA+EN+Final.pdf)

<sup>20</sup> European Commission, 'Towards a Single Market Act: For a highly competitive social market economy' Brussels, October 2010. <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:2010:0608:FIN:EN:PDF>

<sup>21</sup> In fact in many parts of Europe SMEs did not benefit in any way from the credit boom the preceded the crisis. A very good example appears to be Italy, as discussed in Panetta, F. and Signoretti, F. M. (2010) 'Domanda e offerta di credito in Italia durante la crisi finanziaria' Banca d' Italia Occasional Paper no. 63

[http://www.bancaditalia.it/pubblicazioni/econo/quest\\_ecofin\\_2/QF\\_63/QEF\\_63.pdf](http://www.bancaditalia.it/pubblicazioni/econo/quest_ecofin_2/QF_63/QEF_63.pdf)

In its recent impact assessment, the Bank of International Settlements (BIS) has estimated that higher capital requirements will have a modest effect on economic growth, but has been unable to model their effect on lending to SMEs – something which it acknowledges as a risk to its estimates. Much will depend on the details of implementation but also on the responses of lenders, who may well be provided with perverse incentives. An example of this is the use of a target leverage ratio in establishing capital requirements – there is a strong possibility that this will incentivise banks to seek out higher returns at the expense of loans to SMEs.

The Bank rightly expects that the effect of Basel III on SMEs is likely to be disproportionate<sup>22</sup> and it is encouraging that the Commission has committed to a detailed impact assessment,<sup>23</sup> taking advantage of the new regulations' generous implementation schedule. Transparency for SMEs would also be increased if banks were to make available to SMEs information about how the risk classification of their facilities and loans the Basel regulations.

## **Engaging proactively with policymakers**

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European SMEs' access to finance will continue to be a significant issue in the recovery. However, it will now revert from being a question of business survival to one of business growth. In this new environment, business organisations and the accounting profession should engage more proactively with the EU institutions. It is very positive that the Commission is now firmly committed to the Access to Finance agenda, as demonstrated by the permanent status given to the SME Finance Forum.

## **Recommendations:**

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### **Accountants**

Accountants in business and in practice need to continue to support clients through the fund raising process, not only by liaising with providers of finance but also by educating owner-managers where appropriate.

The profession is uniquely placed to act as an unbiased intermediary, by preparing reliable information on SMEs' trading performance and prospects. Accountants can encourage business owners to see accurate accounts (combined with added assurance where necessary) as a means of reducing information asymmetries between businesses and banks, and so reducing the total cost of capital that comprises search, credit assessment and transaction costs, plus interest charges and the risk premium.

Accountants can work with SME clients to ensure that working capital management is as effective as possible, thus helping them to avoid becoming over-reliant on external finance.

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<sup>22</sup> BIS (2010) *Assessing the macroeconomic impact of the transition to stronger capital and liquidity requirements – Interim Report*, August 2010 <http://www.bis.org/publ/othp10.pdf>

<sup>23</sup> EC (2010) *Conclusions of the SME Finance Forum*, May 2010 [http://ec.europa.eu/enterprise/policies/finance/files/conclusions\\_sme\\_finance\\_forum\\_en.pdf](http://ec.europa.eu/enterprise/policies/finance/files/conclusions_sme_finance_forum_en.pdf)

## ***Governments, Regulators and Central Banks***

Authorities at the national level have a role to play in promoting transparency in the credit markets for SMEs. In so doing they can help reduce information asymmetries between lenders and borrowers and lower transactions costs. Increasing the availability of information that is relevant to credit decisions and ensuring that it is prepared to widely accepted standards could make a substantial difference, as would banks informing SMEs about the allocation of their loans to the Basel risk classifications (E,B, D etc).

Moreover, national authorities need to bear in mind that SMEs' financial reporting is driven to a great extent by their own tax regimes. These can often provide incentives for SMEs to make artificial disclosures that can put off credit providers.

## ***EU Institutions***

As Europe's influence on the reporting practices of SMEs grows, the EU institutions should aim to facilitate the production and publication of accurate historic and prospective accounting data for SMEs so that it is easy for banks and credit rating agencies to obtain reliable information that can be easily interpreted.

They should continue to promote carefully designed and implemented mutual guarantee schemes in Member States and seek ways to improve liquidity in the secondary market for SME-issued (and often government-backed) securities. Similarly, equity funding to SMEs through the European Investment Fund and ERDF (e.g. for regional venture capital funds) should be further explored in order to provide additional realistic options to smaller businesses. This may have to include a re-evaluation of regulations that unintentionally raise the costs or constrain the availability of funding for SMEs e.g. through second tier stock markets.

The Commission should also to conduct a rigorous impact assessment of the Basel III proposals. Of particular concern is the extent to which these will affect smaller banks who are not the primary target of the Bank of International Settlements, and of course lending to SMEs, which contributed very little to the causes of the recent banking crisis.

## ***About FEE***

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FEE (Fédération des Experts comptables Européens - Federation of European Accountants) represents 43 professional institutes of accountants and auditors from 32 European countries, including all 27 EU Member States.

In representing the profession, FEE recognises the public interest. FEE has a combined membership of more than 500.000 professional accountants working in different capacities in public practice, small and larger firms, business, public sector and education, who all contribute to a more efficient, transparent, and sustainable European economy. To learn more about FEE and about the accountancy profession in Europe, read the FEE 2009 Annual Review, downloadable from our website ([www.fee.be](http://www.fee.be)).