



Financing small businesses: Recommendations for action

What are the best ways of improving the flow of finance to small firms? The European Commission, the Member States and finance professionals have recently looked at ways that promise to improve the situation of many SMEs. This summary presents the key conclusions of five reports that have reviewed both loan and equity finance. These recommendations are addressed to policy makers, banks and SMEs, and complement the conclusions on seed investment that were published in March 2007.

For policy-makers, banks and SMEs:

More transparency between banks and SMEs

The European Commission organised its Fifth Round Table between banks and SMEs from 2006 to 2007. This Round Table looked at transparency and dialogue between banks and SMEs; mezzanine finance; and the securitisation of lending to SMEs. The objective was to draw up an inventory of good practices in these fields. Participants included SME organisations, bank associations, the accounting profession and mutual guarantee societies.

The Capital Requirements Directive has increased the use of rating procedures and credit scoring systems in banks, having also an effect on many of their SME customers. To ensure a good rating, it is essential to be aware of the factors influencing it. If SMEs can improve the quality of information they supply to banks, they may obtain better credit terms reflecting their real creditworthiness. Thus increased transparency and a constructive dialogue between the two parties are essential. Therefore, the Round Table made the following recommendations:

- ***Banking associations should initiate or pursue a dialogue with SME organisations at national level about ways of increasing mutual understanding. This process should be fostered by public policy makers who should provide a regular forum for such discussions.***
- ***To improve the quality of firm information provided to banks, SMEs should have the tools for enhanced transparency. To this end SME organisations should help their members with their understanding of financial terminology and concepts by developing tutorials and glossaries.***

Recommendations

For financial institutions and SMEs:

Combining debt and equity

Mezzanine finance that combines features of loans and equity (for example subordinated loans) can help to finance the start-up and expansion phases of SMEs, including innovation and business transfers. It can be an important complementary source of finance for firms. Although the use of mezzanine finance instruments has recently expanded, they remain little used compared with normal loan financing. SMEs in some Member States have a choice of a wide range of mezzanine products, but in others there is a lot of ground to make up.

The traditional users of mezzanine finance are larger and well-rated SMEs that often require amounts in the region of €2 million. Other SMEs might have smaller needs, including those family-owned companies that are looking to finance the transfer of ownership. These more limited financing needs can be for amounts smaller than €250 000.

Providing suitable amounts of mezzanine finance to smaller and lower rated SMEs is essential to expand the use of this form of finance. This can be facilitated through mechanisms that help private issuers of mezzanine finance to share their risks. To foster the development of the market, the Round Table identified some key actions:

Recommendations

- ***Financial institutions that have the task of improving SMEs' access to finance should develop programmes of mezzanine finance focusing on smaller amounts. In particular, securitisation of such mezzanine finance should be facilitated and the Member States should encourage the expansion of the mezzanine finance market overall.***
- ***Banks, banking associations, financial advisors (for example accountants and chambers of commerce) and SME associations should consider introducing information programmes which would educate SMEs about innovative financing tools such as mezzanine finance.***

For policy-makers and banks:

Increasing lending volume with securitisation

Removing loans from banks' balance sheets by issuing marketable securities against interest and repayment streams can be an important source of new financing. If banks want to focus on their core strengths, securitisation gives an opportunity to extend the relationship with customer independently of balance sheet constraints and to use credit expertise more intensively. From the customer viewpoint, securitisation does not alter loan conditions or servicing standards.

The securitisation of bank lending to SMEs has become more wide-spread in Europe. Despite short-term adverse market developments there might be further medium-term potential to free funds from banks' balance sheets for SME lending. There are several policy initiatives at national and European levels that have sought to increase securitisation. The Round Table identified the following areas for action to increase lending to SMEs through the increased use of securitisation by banks:

Recommendations

- ***Any support from public sources for SME loan securitisation must be made conditional on the banks' ensuring that such transactions add directly value for clients by extending new loans to SMEs so that these will truly benefit from the support given to the transaction.***
- ***In particular, public programs should work closely with the private sector so that the benefits of securitisation programmes would benefit smaller and lower rated SMEs. Such programmes should also broaden the range of financial instruments that can be securitised (e.g. mezzanine finance products). These programmes should also help regional and smaller banks to get access to securitisation.***

For policy-makers:

Easier venture capital investment across borders

Venture capital is essential for financing the growth of innovative SMEs. It is also global, competing for funds and for best investment opportunities. To be able to compete, European venture capital markets need to increase their efficiency and profitability – one way of doing this is to extend the benefits of the single market to venture capital funds by making cross-border investment easier.

In Europe, the venture capital market is fragmented along national lines, which makes cross-border investments complicated, hinders the growth of venture capital funds and lowers investment levels. To facilitate investment in, and the growth of innovative SMEs, the Commission is working on removing obstacles to cross-border investment.

To identify and remove obstacles, the Commission has consulted both investment professionals and the Member States. It is clear that many European venture capital funds are small and do not have the resources to be permanently present in other countries, even if they might want to occasionally invest in them. Many funds are limited by their size as they cannot make large investments nor can they diversify across borders.

In a union of 27 Member States, the fragmentation of venture capital fundraising and investing limits the efficient operation of the industry. Therefore, the Member States should act together to remove the identified obstacles. The goal is that venture capital funds that are registered in one Member State could operate in others without separate structures in each country they want to invest in, and without separate registration and regulation processes.

Apart from exchanging good practices and improving coordination, the experts that the Commission consulted supported in general progress towards the mutual recognition of the existing national frameworks on venture capital funds and made the following recommendations:

Recommendations

- ***The Member States should recognise venture capital funds from elsewhere in the EU as being equivalent to domestically registered funds. This would mean that a fund would be established and registered only in its home Member State but would be able to invest in others with the same terms as domestic funds. For this to happen, the competent Member State authorities should recognise that venture capital funds from other Member States are subject to equivalent regulatory regimes in their home country.***
- ***The same approach should be applied to management companies of venture capital funds.***
- ***These two steps could then gradually lead towards a mutually acceptable regulatory framework that all Member States could adopt if they so wish.***

The Commission will continue to identify and remove barriers for venture capital. In particular, an expert group is reviewing obstacles caused by direct taxation. Further, the Commission will soon report on steps towards a common private placement regime for investors, which could also help raising funds for venture capital.

For policy-makers:

Better regulation of microcredit

Many start-up businesses and self-employed need small loans. However, access to loans under €25 000 can be difficult despite the fact that small firms are crucial for European growth and employment. From policy-making perspective, microcredit can be a tool for achieving goals like improved social welfare, increased employment and further development and growth of small businesses.

Microcredit policies seek to address several policy goals and target groups. These policy objectives are reflected in the variety of regulations that govern providers of microcredit. Two Member States, France and Romania, have specific legislation on microcredit institutions, the rest rely on general banking and company legislation. When microcredit is provided by banks, they are subject to European banking law, but when it is provided by institutions that are not banks, the regulatory framework differs from country to country.

Recommendations

The Commission consulted experts on microcredit from the industry, the Member States and Turkey in order to identify good practices in regulating microcredit. The experts made four recommendations:

- ***Allow lending by institutions that are not banks***

National legislation should allow a range of financial institutions to lend, including institutions focusing on microcredit. European banking legislation does not pose problems in this respect.

This would be especially beneficial for those borrowers that effectively cannot get loans from banks, for example people that are socially or financially excluded. Potential benefits for Member States include reduction in unemployment and its costs if the expanded provision of microcredit leads to increased self-employment.

- ***Avoid setting interest rate caps too low***

Some Member States cap the interest rates that banks can charge. If such caps are too low, they can hinder the provision of microcredit. Microcredit has higher risk and higher administrative costs that need to be reflected in the interest rate. In the long-term, appropriate interest rates on microloans should make risk-adjusted, cost-covering lending to business sustainable.

However, Member States should ensure that there are minimum quality standards for the pricing of microcredit. The information provided must be transparent and conditions for microloans need to be easily understandable to prevent usury and predatory lending.

- ***Ensure minimum legislative standards***

The Member States should pay attention to the framework regulating microcredit providers that are not banks. The issues that need to be addressed do not necessarily need legislation. They include the registration and legal charters of entities; the disclosure of ownership and control; the publication of financial statements; the transparent disclosure of interest rates to clients; and the submission of names of borrowers and status of their loans to credit bureaus.

- ***Create a favourable general environment for micro-enterprises***

A complementary important way to foster demand for microcredit is to reduce the legal, fiscal and administrative barriers that hamper self-employment. The goal is to create a favourable environment for new micro-enterprises, including favourable tax rules and easy business registration.

This summary is based on the following reports:

- *Fifth Round Table between Bankers and SMEs: Transparency and Dialogue; Mezzanine Finance; SME Securitisation*
- *The Regulation of Microcredit in Europe*
- *Removing Obstacles to Cross-border Investments by Venture Capital Funds*

These and earlier reports are available at:

ec.europa.eu/enterprise/entrepreneurship/financing/publications.htm

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