Executive summary

Bank lending is the most common source of external finance for many SMEs and entrepreneurs, which are often heavily reliant on traditional debt to fulfil their start-up, cash flow and investment needs. However, traditional bank finance poses challenges to SMEs, in particular to newer, innovative and fast growing companies, with a higher risk-return profile. Capital gaps also exist for companies undertaking important transitions in their activities, as well as for SMEs seeking to de-leverage and improve their capital structures. Yet, for most enterprises, there are a few alternatives to traditional debt.

Bank financing will continue to be crucial for the SME sector. However, as banks face more rigorous prudential rules and modify their business model, credit restrictions for SMEs will likely persist for the foreseeable future. It is therefore necessary to broaden the range of financing instruments available to SMEs and entrepreneurs, in order to address diverse financing needs in varying circumstances, increase SMEs' resilience to changing conditions in credit markets and improve their contribution to economic growth.

Increasingly complex and interconnected financial markets offer opportunities to serve the needs of the SME sector, but a diverse set of actions is needed to overcome challenges to market development. The present study maps the main features of a broad range of external financing techniques alternative to straight debt, including asset-based finance, alternative debt, hybrid instruments, and equity instruments; highlights key enabling factors for their development; discusses major market trends and obstacles to SME uptake; and suggests some key areas of policy action.

Asset-based finance is a widely used instrument to provide working capital to young and small firms on more rapid and flexible terms that traditional lending. Regulatory reforms that enable the use of a broad set of assets to secure loans have favoured the development of these tools. In some countries, direct public funding and guarantees are used to enhance asset-based financing for SMEs. In particular, factoring is increasingly supported as a means to ease their inclusion in value chains.

Alternative debt instruments in the capital markets, such as corporate bonds, have had only limited usage by the SME sector. To boost market development, policy action has especially focused on transparency and protection rules for investors. In some countries, SME trading venues have been created, the participation by unlisted and smaller companies has been encouraged and regulatory reforms have been introduced to allow *private placements* of corporate bonds by unlisted companies. However, information gaps, illiquid secondary markets and differences in insolvency laws across industry players and jurisdictions still limit the development of these markets.

Debt securitisation and covered bonds, which also rely on capital markets, have developed at a high pace in the past decade, as an instrument for refinancing of banks and for their portfolio risk management. However, in the wake of the 2008-09 financial crisis, they have come under scrutiny, as one 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 an efficient and transparent securitisation market to extend SME lending and measures have been introduced at different levels to re-launch the market.

Crowdfunding has grown rapidly in recent years, although it still represents a very minor share of financing for businesses and mainly serves to finance specific projects rather than broad enterprise needs. Donations, rewards and pre-selling currently lead the industry, but peer-to-peer lending and equity based crowdfunding are expected to play an increasing role in the future, particularly as reforms are introduced in some countries to lift the ban on equity investments and increase transparency in the market.

Hybrid instruments, such as mezzanine finance, represent an appealing form of finance for firms at a turning point in their life cycle, which need a capital injection, but have limited access to debt financing or equity. As they require stable earning power and market position, and a certain level of financial skills, these techniques are not well-suited for many SMEs. Nevertheless, in recent years, with the support of public programmes, hybrid tools have become increasingly available to SMEs with lower credit ratings and smaller funding needs than what would be the practice in private capital markets.

Private equity investments, such as venture capital and angel investing, have developed substantially over the last decades, providing new financing opportunities for innovative and high growth start-ups, although the global financial crisis severely affected investments. Policy makers have placed increasing attention on these markets, mainly through supply-side measures, such as tax incentives, direct investment and co-investment, and support to industry networks and associations.

Public listings of SME equity have the potential to provide funding to innovative and high-growth SMEs, but markets are currently small. Difficulties include high listing and maintenance costs, administrative and regulatory burden for SME, but also the lack of an equity cultural and inadequate management practices in small businesses. Investors are deterred by high monitoring costs relative to the level of investment and low levels of liquidity. Recent regulatory approaches recognise that these platforms may require specific regulation and infrastructure and policies have been addressing the liquidity problem, through tax incentives and encouragement of retail investment.

Common obstacles exist for SMEs to reap the benefits of a more diversified financial offer. First, the limited awareness and understanding about alternative instruments on the part of SMEs, the difficulties by SMEs in dealing with investor due diligence requirements and the low quality of investment projects have slowed the development of these markets. In addition, the large heterogeneity and opacity of the SME sector contribute to increase the risks perceived by investors and the financing costs for SMEs.

Furthermore, recent regulatory reforms, which aim at making the financial sector safer, are perceived to be unduly onerous by some investors, who are also affected by the enduring uncertainty arising from expected regulatory revisions. In some countries, the public share of funding in higher risk segments has significantly increased in the aftermath of the financial crisis, as governments stepped in to fill the gap left by private investors' withdrawal.

Finally, the evidence base about SME use of alternative instruments is currently patchy, which limits the capacity of investors to monitor the market, as well as the design, implementation and assessment of policies.

A diverse set of actions is needed to overcome these challenges, including:

- **addressing SME skills gap in finance** to improve their strategic vision for their financing needs, understanding about alternative finance instruments and ability to access them;
- **implementing regulation that navigates potential trade-offs** between financial stability, investor protection and the opening of new financing channels for SMEs;
- **developing information infrastructures for credit risk assessment** to reflect more accurately the level of risk associated with SME financing and encourage investors' participation;
- **implementing policies that leverage private resources and develop appropriate risk-sharing mechanisms** with the private sector, to finance innovative and high-growth SMEs;
- **improving the evidence base** to better understand the different needs of the SME sector and how evolving financial markets may respond to them, as well as to enhance policy making.

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