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Chapter 8

Policies for financing

Financing business creation and development is a challenge for all entrepreneurs, but those coming from disadvantaged and under-represented groups face even greater obstacles. Some will experience discrimination in the credit market while others will have difficulties because of lack of savings, collateral and credit history or lack of knowledge about financing sources. This chapter examines the barriers, examines the finance sources, including new alternatives such as mutual guarantees, bootstrapping and crowdsourcing, and explores how policy can help.

Barriers in access to finance

Box 8.1. **Key findings – Barriers in access to finance**

- Entrepreneurs from disadvantaged and under-represented groups tend to face greater barriers in access to financing than the general population, related to lack of collateral, lack of credit history, lack of experience and low credibility with loan officers.
- Financial markets do not necessarily discriminate. Differences in access to finance also result from structural weaknesses in the many of the businesses run by disadvantaged and under-represented groups, which are often in activities with relatively low barriers to entry and high failure rates.
- Discouraged entrepreneurs are people with good business projects who do not seek external credit for reasons such as lack of communication with banks and a belief that they will not qualify. The scale of the problem of discouragement can be as important as loan rejections.
- Difficulties in access to finance can lead entrepreneurs to downscale their business ambitions and operate under-capitalised businesses.

Women entrepreneurs

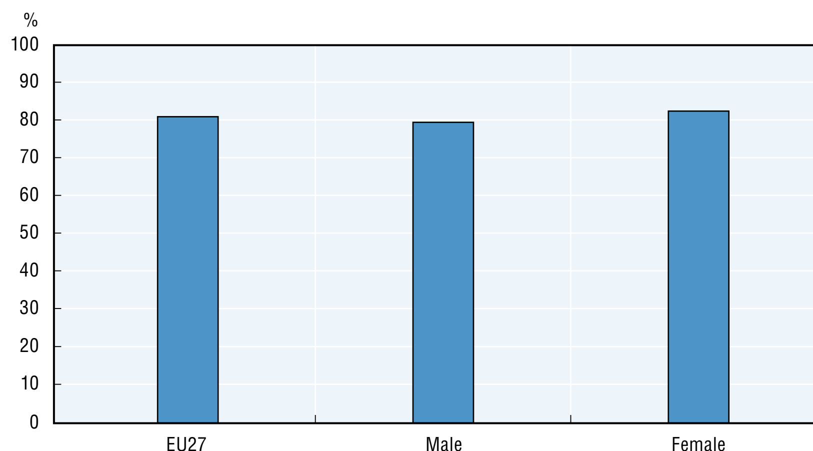
The banking sector favours male entrepreneurship over female entrepreneurship to the extent that more credit is provided to sectors in which men are over-represented while providing limited credit to home-based and part-time businesses, both of which are more common among women. Thus while women entrepreneurs are only slightly more likely to report challenges in accessing start-up financing than men (Figure 8.1), there is other evidence that women face particular problems that may lead them to downscale their business ambitions and rely on internal funds.

Madill et al. (2006), for example, find that male entrepreneurs have more continuous relationships with lenders than women, and that this positively influences their ability to raise finance. Poor relationships are sometimes associated with a patronising attitude on the part of male loan officers, and there is evidence that female loan applicants are more closely scrutinised on their business knowledge than men (Carter et al., 2007). Being a woman, therefore, can increase the probability of perceiving financial barriers to business creation (Roper and Scott, 2009; Hill et al., 2006).

Women entrepreneurs are also more likely than men to be discouraged borrowers, i.e. people who do not apply for loans because they believe that the loans are not appropriate or that they will not be successful (see Box 8.2). For example, Muravyev et al. (2009) found that in Europe and the Commonwealth of Independent States, nearly 60% of women-owned firms and 44% of male-owned enterprises did not get a loan either because they were discouraged from applying or because their application was rejected, with the first case being predominant.

Figure 8.1. **Difficulty accessing start-up financing, 2009**

Proportion that strongly agree or agree that "It is difficult to start one's own business due to a lack of available financial support"



Source: European Commission, 2009, "Entrepreneurship in the EU and beyond – A survey in the EU, EFTA countries, Croatia, Turkey, the US, Japan, South Korea and China", Flash Eurobarometer 283.

StatLink http://dx.doi.org/10.1787/888932927345

Box 8.2. **Discouraged borrowers**

Entrepreneurs with good business projects from disadvantaged and under-represented groups may be discouraged from approaching external credit providers for a number of reasons. Cultural and communication barriers could prevent them from approaching lenders, they may hesitate because of the high perceived cost of credit, or they may simply believe that they will not qualify for credit even if they do (this may particularly apply to entrepreneurs from low-income and less-qualified groups). The effect of this discouragement effect can be as important in scale as actual loan denials (Kon and Storey, 2003; Levenson and Willard, 2000).

What complicates this picture is the different nature of businesses started by women and men. Women entrepreneurs are more likely to start businesses with smaller external financial requirements than men, and therefore the problem of discouraged and rejected borrowers could have less impact on their decisions to start a business (Roper and Scott, 2009). In their study, Muravyev et al. (2009) found that somewhat fewer women-owned firms reported needing a loan compared to men-owned businesses in both longstanding and newer EU member states. It is not clear, however, to what extent women entrepreneurs downscale their ambitions as a result of the problems they face or expect to face in accessing external finance.

It is difficult to establish the degree to which women entrepreneurs face discrimination in the credit market (see Box 8.3). In this respect, the Muravyev et al. (2009) study suggests that after controlling for business performance and the owners' creditworthiness, women entrepreneurs in Europe are not discriminated either in terms of higher loan denial rates or higher interest rates. More recently, however, a study on Italy found that women do pay higher interest rates on overdraft facilities after controlling for several characteristics of the borrower and of the bank and the structure of the banking sector (Alesina et al., 2013). There is also research from the United States that suggests that women can suffer from more credit denials after controlling for a range of business and personal characteristics (Cavalluzzo et al., 2002).

Box 8.3. **Discrimination in access to entrepreneurial finance**

Discrimination involves provision of different levels or terms of access to financing for people with the same quality of entrepreneurial projects and personal financial characteristics, based solely on factors such as age, gender, disability or ethnic group. Such discrimination can be of various kinds.

Non-economic discrimination

Non-economic discrimination refers to a taste-based preference in which a discriminating actor goes against a rational interest and instead follows a personal preference. In credit markets it occurs, for example, when, all else being equal, a company managed by a native adult man is given credit, while one run by a woman or a member of an ethnic minority is not. In this case, the lender is forsaking the chance to gain more in the face of equal profit prospects only to satisfy emotional preference. In a competitive market, such behaviour would lead to the exit of the discriminatory lenders to the advantage of rational lenders that do not include taste-based preferences in the decision-making process (Becker, 1971).

Statistical discrimination

Statistical discrimination is more subtle and happens when the lender, to cope with the information asymmetries associated with the lending process, ascribes to the borrower the average characteristics of his/her demographic group (Phelps, 1972). So a migrant entrepreneur applying for credit will be associated with the average education and wealth of his/her ethnic group, regardless of whether they reflect his/her personal human and financial capital. Another example consists in "bank redlining", which corresponds to a bank's decision to restrain the provision of credit in distressed urban areas with a large proportion of high risk clients. If an ethnic group is overly represented in the redlined neighbourhood, it will suffer from statistical discrimination without necessarily being discriminated against because of race.

Some influences on discrimination

Two additional factors are likely to affect discrimination in credit markets. First, concentration in the banking sector has an impact because lending institutions operating in a non-competitive environment will be less exposed to loss of market share in case of prejudicial behaviour towards certain categories of borrower. Second, lending technologies could also lead to discrimination if credit scoring features are poorly adapted. However, neither relationship lending nor transactions lending is flawless. The former enables the loan officer to make a personal judgement on the borrower's reliability, a judgement that can be tainted by racial or gender considerations. The latter may produce discrimination to the extent that lower scores may be assigned for example to enterprises located in deprived neighbourhoods or to part-time businesses more likely to be run by women without regard to the true capacities of the individual entrepreneur and their project.

Identifying discrimination

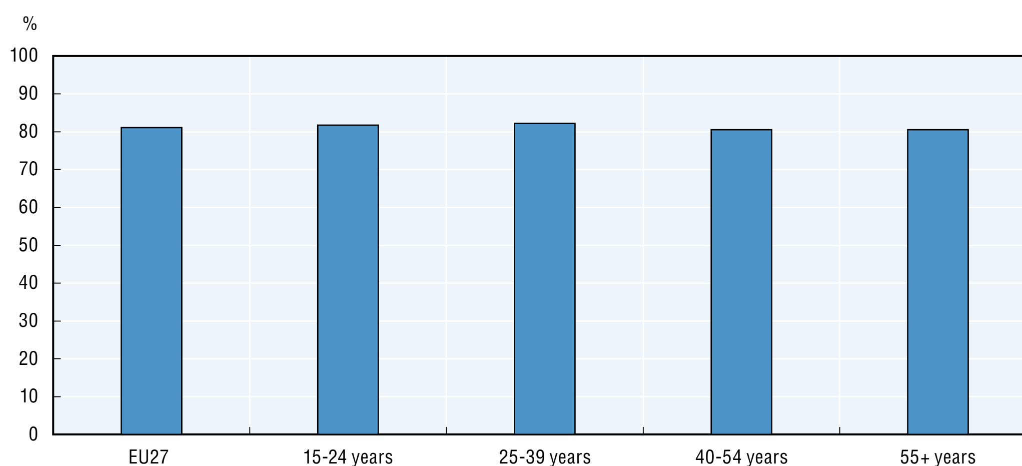
Caution is needed when seeking to identify discrimination. For example, credit market statistics regularly show that disadvantaged groups are more affected by credit rationing, are more likely to be "discouraged borrowers" and pay higher fees and higher interest rates on credit. However, unfavourable loan decisions could be the result of the structural weakness of the businesses managed by migrants, women or any other member of a disadvantaged or under-represented group. In that case, the bank's adverse lending terms would be rational and justified by the poor financial ratios of the applicant firm (e.g. profitability, solvency, debt/equity ratio). Firm-specific factors need to be controlled for before we can conclude that an entrepreneur is discriminated because of his/her personal background.

Young entrepreneurs

For young people, access to finance for business creation and self-employment can be constrained by several factors related to age: lack of collateral (reflecting lower savings), lack of credit history, and lower levels of business experience. In addition, young nascent entrepreneurs are likely to face higher credibility issues in starting a new business, i.e. to suffer from non-economic discrimination. On the other hand, young people are not necessarily more likely than their older counterparts to see access to finance as a barrier to start-up (see Figure 8.2).

Figure 8.2. **Difficulty accessing start-up financing, 2009**

Proportion who strongly agree or agree that "It is difficult to start one's own business due to a lack of available financial support"



Source: European Commission, 2009, "Entrepreneurship in the EU and beyond – A survey in the EU, EFTA countries, Croatia, Turkey, the US, Japan, South Korea and China", Flash Eurobarometer 283.

http://dx.doi.org/10.1787/888932927364

As with interpreting the data for women, part of the puzzle relates to the nature of the businesses that young people set up and the extent to which they attempt to create smaller-scale and less capital-consuming ventures because of the difficulties they face in financial markets. In particular, there is a danger that businesses started by young people may be under-capitalised and therefore vulnerable to fluctuations in cash flow.

Senior entrepreneurs

On the surface, it might be expected that older people will face fewer barriers in accessing external finance for business start-up and development than younger entrepreneurs, since they will tend to have greater savings, collateral, entrepreneurship skills and business networks. However, the reality is likely to be more complex. Older entrepreneurs may wish to start businesses in different sectors from those in which they have their previous working experience, which can be difficult to "pitch" to funders. Financial institutions may also be unwilling to fund new business start-ups for entrepreneurs who are nearing normal retirement age, for example because of concerns about potential health and premature death affecting the repayment schedule. This will result in higher loan denial rates or higher debt finance costs due to increased loan insurance fees. Financial institutions can

also be sceptical about the ability of senior entrepreneurs to cope with new technology and develop new ideas. This largely falls in the area of discrimination rather than reflecting real differences with younger counterparts.

Ethnic minority and immigrant entrepreneurs

Ethnic minority and immigrant entrepreneurs are among the strongest users of non-bank and informal finance, such as credit unions, microfinance schemes, and moneylenders, with the problem that although this enables business start-up it may not be sufficient for later business development (Basu, 2006). This may in part reflect discrimination. Smallbone et al. (2003) found that in the United Kingdom, despite being more likely to have formal management training, only 21% of African-Caribbean applicants obtained a start-up loan whereas 34% of white applicants did. A Bank of England survey (1999) of lending institutions concurred that the business experience and business planning skills of ethnic minority entrepreneurs often meet bank loan requirements. Instead, the main barrier was a lack of collateral assets or other forms of loan security (e.g. loan guarantees).

There are significant differences across ethnic minority groups. Thus in the United Kingdom, several studies have found that the African-Caribbean minority is the most likely to encounter problems in credit markets compared both to whites and other minorities such as Asians. Curran and Blackburn (1993) reported that as many as 40% of African-Caribbean people experienced difficulties in business credit markets, while only 33% of Asians and 20% of whites did.

Problems such as more frequent loan denials and higher interest rates for ethnic minority entrepreneurs may also reflect in large part structural weaknesses of the businesses that they run rather than discrimination by finance providers (Bank of England, 1999). Nonetheless, this can result in a discouragement effect that impacts ethnic minority entrepreneurs irrespective of the sector in which they operate (Fraser, 2009). One of the main problems to address is, therefore, an over-representation of ethnic minority entrepreneurs in sectors such as retail, catering, construction and transportation where entry and exit costs are low and failure rates high. This raises the issue of the reasons why many entrepreneurs from this social group develop weaker business projects and how policy actions might help in strengthening these businesses.

Entrepreneurs with a disability

There are several reasons why raising finance may be difficult for disabled entrepreneurs, although there is a relative lack of quantitative evidence to demonstrate and explore these issues. In particular, there are likely to be problems related to stigma and discrimination in lending institutions with respect to perceived capabilities and business risks, and difficulties relating to a greater likelihood of disabled people being "resource poor" and therefore finding it more difficult to put up the collateral required by institutional lenders (ILO, 2008).

THE MISSING ENTREPRENEURS © OECD/EUROPEAN UNION 2013

Finance sources for entrepreneurs

Box 8.4. **Key findings – Finance sources for entrepreneurs**

- Entrepreneurs from disadvantaged and under-represented groups tend to rely too heavily on internal funding and experience significant difficulties obtaining bank loans.
- There are a number of important finance techniques with potential to help address these problems on the supply side, including public loan guarantees, mutual guarantees, microfinance, equity investments and crowd funding.
- Policy action can assist the emergence of alternatives to internal finance through facilitative legal frameworks, subsidised operating costs, capital contributions to funds, brokering of networks of entrepreneurs and matching of entrepreneurs and investors.
- There is also scope for policy to raise awareness about available financial products and techniques such as bootstrapping and to upgrade the skills needed to use them through advice, coaching and financial education.

Entrepreneurs, particularly those from disadvantaged and under-represented groups, have tended to be over-reliant on internal funding without being particularly sophisticated in how they make use of it. A better balance between internal and external funding would often help the growth and survival prospects of their businesses. In terms of external funding, the emphasis both of entrepreneurs and policy makers has been particularly on loans, or debt finance. There are certainly problems that need to be addressed in the debt finance market. However, it is important not to neglect other newly-emerging sources. These sources include equity finance, mutual guarantee schemes, crowd funding, microfinance and bootstrapping. Here we discuss the potential of these funding sources and key actions that public policy can take in each case.

Internal and informal finance

Entrepreneurs face a number of problems in accessing finance for business creation and operation, both on the supply and the demand side of finance markets. One of the issues is that they tend to rely too heavily on internal funding as opposed to external finance, and therefore lack sufficient investment capital and working capital to support business growth and operation. For example, female and young entrepreneurs are more likely than male and senior ones to draw on the support of family and friends to start up a business. Indeed, for a number of disadvantaged and under-represented groups of entrepreneurs, internal finance may be particularly restricted, potentially leading them to downscale their business ambitions if they cannot access external finance (OECD-European Commission, 2013 forthcoming).

The issue of reliance on internal funding can be resumed by three tendencies. One is reliance on the "three F's", in other words on finance from the founder and her or his family and friends. This is likely to be flexible and low cost, but also tends to be limited to small amounts. The second is to operate businesses with few fixed assets and high shares of trade debt (Cressey and Oloffson, 1997). While trade debt is a useful funding source, again only small amounts of funding can be put together in this way for investment. The third tendency is for entrepreneurs to use overdraft facilities more than bank loans (OECD, 2012). Overdrafts are clearly a potential funding source that entrepreneurs should be aware of, but one which tends to come with high costs. Unfortunately, these three tendencies

appear to be particularly common among disadvantaged and under-represented groups in entrepreneurship and self-employment.

A strong reliance on internal financing can constrain the growth and survival of businesses because of a lack of investment and the lack of a financial buffer to enable them to ride out temporary drops in revenues or increase in costs and to avoid the vagaries of short-term credit recall or denial decisions by informal lenders.

In this context, it is important for policy makers to inform entrepreneurs about the various types of financing available to them, the advantages and disadvantages of the different finance types and their potential consequences for the business, and how to achieve a good mix of internal and external funding. It is also important for public action to seek to improve the supply of external funding so that entrepreneurs have the opportunity to access them and therefore will be less inclined to stick with internal resources.

Bank loans

There is a key underlying problem in credit markets that creates difficulties for entrepreneurs from any background to obtain financing, and tends to be exacerbated for people starting businesses from disadvantaged and under-represented groups. The problem is a lack of information available to lenders to assess risk, and a high cost of obtaining any information that is available. To a large extent, this goes with the territory of business start-up since the projects involved will not have a history of pay back, while key information about market potential and robustness of business organisation will only be known by the entrepreneur and will not be easily accessible to the lender. This makes it difficult for banks to decide whether or not to provide credit.

In theory, the problem could be resolved by charging higher interest rates to any borrowers who are unable to provide the full range of information demanded and who may be risky. However, the interest rate does not simply correspond to the price of the loan, but also functions as a screening device. Not only would increasing interest rates pull in subprime borrowers and stave off prudent ones (i.e. adverse selection), but they would also provide an incentive for the borrower to undertake risky projects to pay off the loan and minimise the cost of default (i.e. moral hazard) (Stiglitz and Weiss, 1981). These problems explain the tendency of banks to require collateral to protect themselves against borrowers' loan defaults. In addition, since banks face fixed costs in making a risk assessment of the borrower and monitoring their repayment it is relatively expensive for them to manage loans for small amounts. They may therefore avoid this market or resort to relying solely on credit-scoring techniques rather than relationship-based lending in order to keep costs down.

The interplay of these factors causes credit rationing, i.e. a gap between credit demand and supply, which disproportionally impacts on new businesses. The problem is therefore straightforward. People starting businesses and moving into self-employment often have limited credit history and independent information on their business prospects that they can share with a bank, they lack collateral and savings and they want to borrow small amounts. The problems tend to be even more serious for entrepreneurs from disadvantaged and under-represented groups, because they are more likely to be short of collateral assets and savings than the average business owner, they tend to want very small loans, they often lack certified credit history and they may face negative perceptions of their capabilities from lenders.

One of the most promising public policy approaches to improve access to bank loans by disadvantaged and under-represented entrepreneurs is through the establishment of loan

guarantee programmes aimed at these communities. The approach typically involves government creating or contributing to a fund operated by a public or private financial institution, which then offers banks guarantees for loans that they make to target groups corresponding to the objectives of the fund. This lowers the risk run by the banks and therefore increases their willingness to lend without collateral. While there will be public costs associated with the fund's share of losses on defaulting loans, there are also some potential returns from fees charged to banks and a share of interest charged to entrepreneurs.

Loan guarantees present several advantages from the point of view of policy makers. They draw on the expertise of the banking sector for credit risk assessment and loan monitoring. Their cost will largely depend on the loan default rate, which increases the incentive to run the programme properly, for example by actively involving the banking sector and setting clear operational rules (e.g. firm eligibility, coverage ratio, guarantee period, etc.). They favour the integration of clients into the mainstream credit system rather than target them through ad-hoc interventions. And they can show commercial banks that entrepreneurs from disadvantaged and under-represented groups can be a viable line of business.

A different issue affecting debt finance and applying specifically to Islamic entrepreneurs is the need for financing that meets religious requirements. This can be relevant for those entrepreneurs, mainly from ethnic minorities, who would not search for credit unless it is compliant with Sharia law forbidding interest payments. Until now, Islamic finance has predominantly been in large investments rather than small business lending, but policy makers can work to expand its focus (OECD-European Commission, 2013, forthcoming). Box 8.5 discusses this issue.

Box 8.5. **Islamic financing**

Islamic business is built on strong ethical principles enshrined in Shari'a law prohibiting the charging or paying of interest for the use of money (Shanmugam and Zaharia, 2009; Qfinance 2012). As a consequence, a number of alternative mechanisms have been developed by Islamic financial institutions to mobilise funds to support business start-ups by Islamic entrepreneurs while ensuring the sustainability of the financial institution. The basic principle is the creation of partnerships between the bank and the entrepreneur for risk sharing and profit sharing.

In order to raise funds for lending, Islamic financial institutions can use deposit mechanisms such as *wadiah*, which provides the depositor with a discretionary gift instead of interest. Alternatively, they can generate external resources with instruments such as *waaf*, which is a charity mechanism that generates income flows from long-term assets such as real estate (Dusuki, 2012).

In the partnership with the entrepreneur, the financial institutions can offer participatory mechanisms such as *mudarabah* to share profits or losses with the depositor or *musharaka*, which involves payments to the bank that vary in line with the entrepreneurs' profits.

The strong ethical principles involved often mean that a business run on Islamic principles will seek to deliver social benefits to the community. Islamic businesses must operate with fairness, integrity and equity, treating everybody equally with a high level of trust and spirit of cooperation. Islamic financing does not rule out investment and credit financing, but funders will be treated as "stakeholders".

Box 8.5. **Islamic financing,** cont.

There has recently been a global growth in the popularity of Islamic financial institutions, led by financial institutions and banks from the Middle East (Shanmugam and Zharia, 2009). However, European experience has been less successful (Stressman Foundation, 2012), and Islamic financing is still limited in several European countries with large Muslim populations such as Germany, the Netherlands, France and the United Kingdom. Furthermore, there have been symbolic failures of funds that were established in Luxembourg and Germany (the Meridio fund in 2010 and the Al-Sukoor fund of the Commerzbank in 2005 respectively), which appear to be related in part to low incomes and low economic activity rates in the target populations (Stressman Foundation, 2012).

Mutual guarantee schemes

Mutual guarantee schemes work in a similar way to loan guarantees offered by government in that the banks' lending risks is reduced by offering guarantees for part of the amount of the loans offered. However, in this case the guarantee is in part offered by a formal association of entrepreneurs. The government is also involved, typically by providing a second-level counter-guarantee on loans in order to increase the volume of loans that the association can cover.

The key requirement for the establishment of mutual guarantee approaches is that business owners form an alliance through which they agree to share a joint and "mutual responsibility" for loan defaults by members, in return for the opportunity to access a loan on good terms as long as their request is evaluated positively by other members. Members contribute a capital amount to the mutual guarantee fund, which is then used to back loans, and pay loan application fees when they seek a guarantee. The schemes tend to operate at local level, in a city or region, among communities of like-minded entrepreneurs. For example, these schemes are often hosted by existing business associations, such as chambers of commerce, where networks are sufficiently well established to form the basis for membership of the programme and to share information between members. Business associations can also assist with the establishment of a guarantee fund.

Mutual guarantee schemes help to address two key problems that affect the debt market for disadvantaged and under-represented entrepreneurs. First, given high risks for the banks, they tend to ask for collateral, which new business creators from disadvantaged and under-represented groups may not be able to provide. The guarantee is able to substitute for this collateral. Second, they help address the problem of lack of information to assess risk, since, in addition to the risk assessments by banks, which remain the final decision maker on the issue of the loan, the members of the mutual guarantee schemes undertake their own first risk assessments in deciding which loans to guarantee. In doing so, they use their detailed knowledge of the other entrepreneurs in the group, the sectors they work in, the market prospects and the projects the peer entrepreneurs are developing.

Members have an incentive to pay back the loan in order to not to lose their capital contribution to the scheme and to maintain their reputation with their peers. In effect the scheme provides not only financial capital but also social capital. These features of mutual guarantee schemes offer benefits to both entrepreneurs and banks, through lower default rates and default losses for banks and increased access to longer lines of credit at lower interest rates to the entrepreneurs.

Mutual guarantee schemes are popular in several European countries, particularly in Germany, France, Spain and Italy. In Italy, they account for 37% of the total volume of

guarantees to SMEs (Columba et al., 2009). However, the approach is growing in importance more widely in Europe (European Commission, 2006). According to statistics held by the European Association of Mutual Guarantee Societies (AECM), the volume of guarantee portfolios in these schemes was over EUR 78 billion in 2011, and the number of small firm beneficiaries had increased from two million in 2006 to over three million in 2011 (AECM, 2012 *www.aecm.be*). It has been suggested that a greater tradition of cooperation and networking and higher levels of social capital may explain the difference in success in terms of implementation across countries, together with certain differences in legal environments. Similarly, countries where entrepreneurs have traditionally had easier access to mainstream channels of credit are less likely to have seen the emergence of these finance mechanisms at local level.

Although mutual guarantees have tended to be most common in general small business lending, there may be latent potential for creation of such schemes among entrepreneur communities from disadvantaged and under-represented groups working in the same business sectors, especially those with strong networks and social capital (e.g. entrepreneurs from certain ethnic minorities). For example, support for the creation of mutual guarantee associations for youth, women, or ethnic minorities, are all options. At the same time, however, mutual guarantee schemes are generally industry based, and it is therefore likely to be necessary to combine two characteristics in the members of any given scheme: membership of a particular target disadvantaged or under-represented group (women, youth, ethnic background, etc.) and knowledge of each other's businesses or sectors.

Public policy can take a number of actions to facilitate the emergence of such schemes. First, it can set a facilitative legal framework. Second, a public agency or a small business association can broker the creation of mutually supportive groups of entrepreneurs interested in participating in a scheme and create or host a fund. Third, public subsidies can be offered, for example contributions to the registered capital and/or operating costs of the association. Fourth, public counter-guarantees can be offered to reduce the risks run by the banks and association members, acting as an incentive to encourage participation.

There are also some features of good practice in mutual guarantee schemes that public sector can promote. First, it is likely to be important to involve a commercial bank as a partner in running funds. Second, banks should continue to undertake a credit risk assessment to keep down the rates of loan default, implying the need for the scheme to be designed so that they continue to carry a small part of the default risk (e.g. 10 or 20%) and are therefore motivated to apply some degree of due diligence in the examination of loan applications. Third, maximum default rates should be set beforehand to avoid the schemes diverging from their original nature and purpose (effectively becoming simple business subsidies rather than loan facilitators). Fourth, financial and business development advice should be offered to entrepreneurs along with the loan guarantees in order to increase their chances of business success and reduce the likelihood of defaults. Finally, well-designed programmes should aim to phase-out reliable borrowers from the scheme, since they should be able to obtain mainstream, non-guaranteed financing. If a credit guarantee scheme has a very low level of default, this could signal that it is being used to guarantee borrowers who do not need such guarantees, instead of the weaker firms (e.g. in terms of capitalisation or collaterals) for which these programmes are envisaged.

Microfinance

The original microfinance model was developed by Grameen bank in Bangladesh to help rural women to develop businesses that could provide them with additional incomes.

The basic approach has now been adopted around the world for the provision of small loans to entrepreneurs, which in practice can be taken to be for amounts of less than about EUR 25 000 in European Union economies (European Microfinance Network, 2010). Microfinance schemes have been developed to assist entrepreneurs who may be perceived to be high risk by banks due to limited resources, lack of assets that could be used for collateral, limited income or limited qualifications. Box 8.6 describes such a programme run by Adie in France.

Box 8.6. **Adie, France**

Adie is a microfinance provider that aims to support and finance businesses started by the unemployed who are unable to receive start-up financing from a bank. It offers three types of finance, typically for less than EUR 11 000:

- Loans of up to EUR 6 000 at market interest rates.
- Start-up grants funded by the French government or by local authorities.
- Non-interest bearing subordinated loans.

Finance is available to any type of project, although the majority of entrepreneurs receiving financing from Adie come from the retail and service sectors. Loans are granted by a committee that consists of volunteer business professionals (e.g. accountants, bankers) and permanent staff. Criteria used to grant loans include the capacity and motivation of the entrepreneur as well as an assessment of the feasibility of the project. In addition to these financial products, a number of business support services are available. Advice is offered by staff and volunteer professionals in the areas of business management, administrative requirements, marketing and business law.

Adie also uses its position in the financial market to work with the government to improve the regulatory framework for microfinance in France.

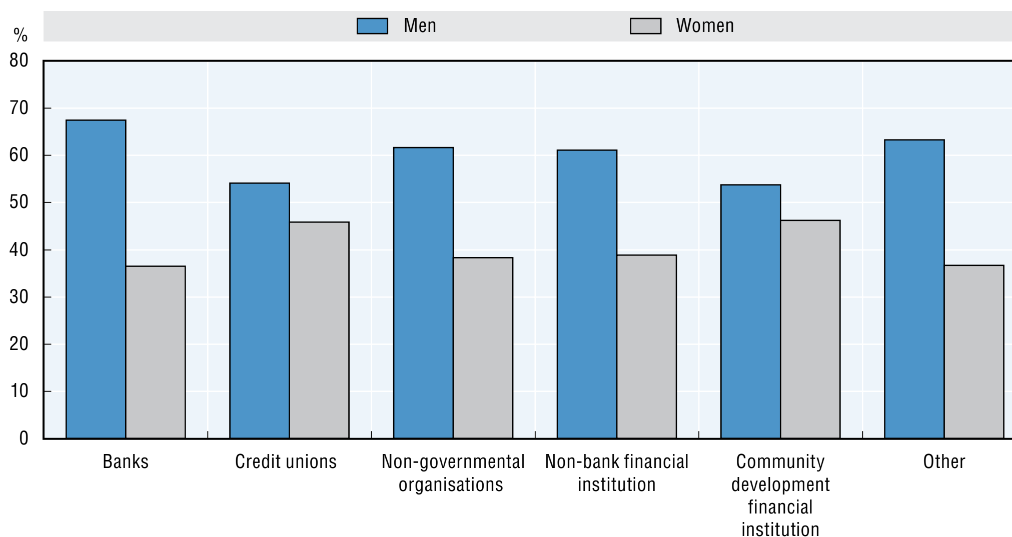
For more information, please see: *www.adie.org/*.

A typical arrangement for micro finance institutions is group lending, which shares similar operating approaches with mutual guarantee schemes discussed above. In group lending, microcredit facilities deal with only one entity (i.e. the group), which simplifies the lending process. Transaction costs are reduced insofar as the approval and monitoring of the loan is partly passed on from the lending institution to the group itself. Similarly, information asymmetries are lowered because groups are more aware than loan officers about the creditworthiness of their members. Collaterals are often not required and replaced by peer pressure, group liability and compulsory savings. Group-lending is not flawless (e.g. peer pressure can sometimes be excessive, group self-selection can result into the exclusion of the most vulnerable members of the group, participation in the scheme takes time and implies sharing of financial and personal information, etc.), but the associated advantages of simplicity underlie its diffusion among women, ethnic minorities and other disadvantaged and under-represented groups (Green, 2005).

Information on the state of the microfinance sector in the European Union is available from the 2011 European Microfinance Network survey, which covered 71 microfinance providers coming from a range of different types of suppliers: banks, credit unions, non-governmental organisations, non-bank financial institutions, community development financial institutions, etc. The survey indicated that some 175 000 loans were made by these organisations, with an average value of approximately EUR 9 000.

Many of these microfinance actors indicated that their clients were financially-excluded individuals such as women, ethnic minorities, immigrants, the unemployed, youth and the disabled. But paradoxically, given the objectives of microfinance organisations, their lending tends to be biased towards less disadvantaged entrepreneurs. As shown in Figure 8.3, microfinance was more likely to go to male entrepreneurs; women received only 42% of the microfinance loans overall, much less than in the developing world where they are the major client, and there was an excess of lending to men over women by all types of microfinance suppliers. There also appear to be gaps for certain other disadvantaged groups such as ethnic minorities, youth and the unemployed. For example, immigrants and ethnic minorities are under-represented among participants in microfinance schemes compared to their incidence in the EU entrepreneurial population. This is likely to reflect in part the lower quality of business projects typically put forward and the greater difficulty in reaching these groups, implying both to higher operational costs and higher loan losses in serving these groups. Overall, the sector is still largely dependent on public support to cover costs, as demonstrated by an average repayment ratio of European microfinance lenders of only 63% (European Microfinance Network, 2010). Schemes aimed at the hardest-to-reach groups might show even lower repayment rates.

Figure 8.3. **Distribution of microfinance loans in the EU, 2011**



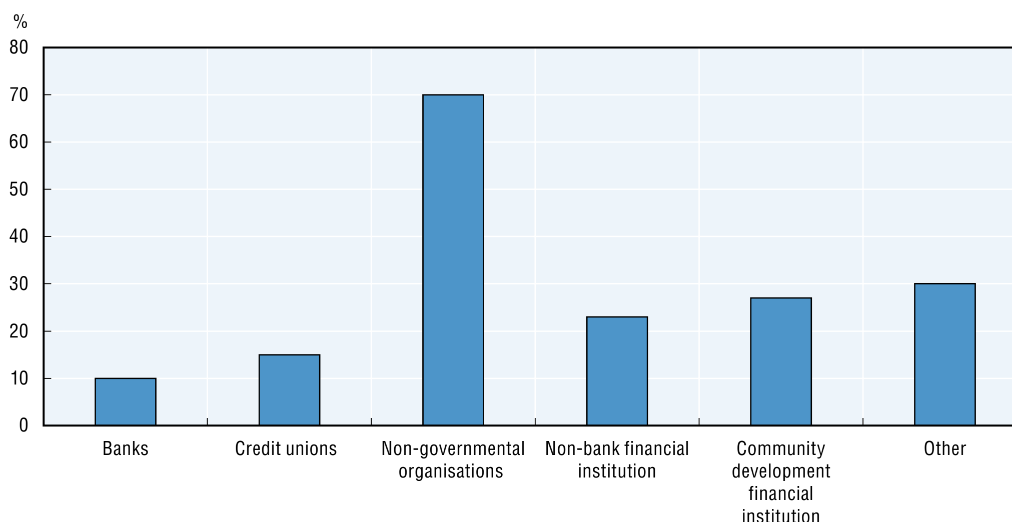
Source: Special tabulations of the 2011 European Microfinance Network Annual Survey (71 members).

StatLink http://dx.doi.org/10.1787/888932927383

Other evidence suggests that the outreach of microfinance organisations towards women is particularly weak in Western Europe. Thus one study suggested that only 35% of microloan clients are women in Western Europe, as against 62% in Eastern Europe, 59% in North America and 84% in the developing world; while as many as 75% of microcredit institutions do not have policy guidelines on women clients, 65% do not have bespoke loan products for women, and 55% do not offer specialised training or assistance to women (Underwood, 2006). In addition, women tend to receive worse terms than men from microfinance providers with regard to both loan size and charged interest rates in France (Brana, 2013).

Another criticism is that few microfinance initiatives provide advice and business support along with a microfinance loan. With the exception of lenders from non-governmental organisations, the EMN European microfinance survey suggests that microfinance lenders in the European Union do not systematically provide business support services (see Figure 8.4). Other evidence also suggests that as many as 30% of European micro finance institutions do not offer support services beyond credit (Underwood, 2006). The offer of business support together with a micro loan is nonetheless a feature of many successful microfinance organisations. However, support services appear to be instrumental to the performance of microcredit programmes. For example, the Prince's Scottish Youth Business Trust combines loans with mentoring for up to two years provided by volunteers from local business communities (please see the policy description for the UK in Part IV for more information). Box 8.8 provides another example of a microfinance institution that also offers coaching, namely Sant Cosme Innova in Spain.

Figure 8.4. **Proportion of microfinance lenders that provide business support services, 2011**



Source: Special tabulations of the 2011 European Microfinance Network Annual Survey (71 members).

StatLink http://dx.doi.org/10.1787/888932927402

There are some significant differences in the microfinance industry between Eastern and Western European countries, both in terms of maturity and objectives of the sector. Thus in Eastern European countries such as Hungary, Bulgaria, the Slovak Republic, Romania and Poland, most microfinance lenders have been active since the 1990s, whereas in Western Europe the microfinance sector is fairly young and still expanding, with many actors setting up only within the last decade (Kraemer-Eis and Conforti, 2009). As a result, the majority of microfinance institutions in Western EU countries tend to be more reliant on public finance sources for both operational costs and loan capital (Kneiding and Kritikos, 2007). Furthermore, microfinance lenders in Eastern Europe tend to have much stronger commercial objectives than those in Western Europe, where focus is more often placed on social objectives (Kraemer-Eis and Conforti, 2009). Consequently, one of the challenges for microfinance lenders in Western Europe is achieving efficient operational models that can maximise both financial and social performance. This challenge is further complicated by the pre-existence of a competitive financial services sector that has an elaborate and well-enforced legal oversight structure (Kraemer-Eis and Conforti, 2009).

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Box 8.7. **Sant Cosme Innova (Microcredit for Migrants), Barcelona, Spain**

This ESF-backed project was set up to test a blend of microfinance and business support to migrants living in the Sant Cosme neighbourhood of Barcelona (where they represent around two-thirds of the population) at a time when the number of job opportunities had dramatically dropped and many were living out of social security payments and informality. A survey of local people without stable employment revealed that 80% were interested in self-employment but that getting access to a loan to start a business was virtually impossible. Most people not only lacked the necessary collaterals but also the confidence and experience to put their case to the bank.

The project partnership brought together a large financial institution with the local social services and other frontline support workers. A non-governmental organisation specialised in providing employment advice to disadvantaged people offered mentoring services, helping clients along the path to self-employment. The European Social Fund supported the project through the EQUAL facility with a contribution of EUR 150 000 matched by an equal contribution by Un Sol Món, a foundation belonging to the Bank of Catalonia (i.e. *Caixa de Catalunya*). The basic product offered by Un Sol Món was a small, flexible loan from as little as EUR 600 to a maximum of EUR 15 000 (the average was EUR 8 000), with a fixed 6% interest rate. The specific terms of the loan were tailored to each person's needs by using "step-lending" methods. Initially, loans were made in small amounts and for short periods, but could be increased in a series of progressive "steps". No collateral was required. The only guarantee was the solidity of the business plan prepared in conjunction with an organisation specialised in providing business support and guidance to disadvantaged groups.

In the two years of operation (2002-2004), 600 loans were disbursed for an overall loan volume of EUR 6 million. The average loan size was approximately EUR 10 000. An estimated 1 000 jobs were created, mainly benefiting women and ethnic minorities. A survey of Sant Cosme Innova's clients additionally showed that 80% reported being better off than before joining the programme and 70% thought that the programme had helped stabilise their business, for example by facilitating its transition from the informal to the formal economy. The one-year survival rate of supported firms was 90%, while the loan default rate was 6%, far below the average for microcredit schemes in the EU. Management costs were also kept down and under 5% of total costs, in line with ESF operational rules.

Microfinance is a relevant policy not only because many people from under-represented and disadvantaged target groups run small-scale businesses that do not need larger resources for start-up and operations, but also because microcredit can be organised around flexible arrangements that make collateral assets unnecessary. Their emergence can be supported by public sector brokerage and subsidised public finance. Further priorities for public policy action are to provide support that will encourage microfinance schemes to better serve disadvantaged and under-represented entrepreneurs groups, such as women and migrants, for example by providing subsidies to programmes or programme modules specifically aimed at these groups and that involve loan capital, interest rebates, or covering operating costs such as credit risk assessment and loan monitoring. Additional services such as financial advice and education and business development training can also be supported through public intervention.

The main advantage of microcredit is that, unlike other business financing instruments (e.g. guarantees and crowd funding), it is a policy specifically designed for disadvantaged

and under-represented entrepreneurs, although policy makers still need to pay attention to the way the scheme is implemented to ensure that it does not diverge from its intended target. Microcredit also helps clients to build a credit history, thus strengthening their future chances of receiving debt finance through mainstream credit channels. On the downside, microcredit organisations are unlikely to become self-sustainable because of the higher risk profile of the entrepreneurs they target and require significant policy support. The 63% average repayment ratio of the EMN-surveyed microcredit providers underlines the dependency of the EU microcredit sector on policy support (EMN, 2010). In theory, the harder to reach is the microcredit's target group, the stronger the public subsidy that policy makers might expect to provide. In practice, evidence from developing countries on default rates on microcredit loans shows that women are more likely to repay than men (D'Espallier et al., 2009).

Microcredit holds a central role in the EU strategy for financial inclusion and inclusive growth. In 2010, the EC Directorate General for Employment, Social Affairs and Inclusion launched the "Progress Microfinance" facility, which represents the first EU-wide initiative specifically designed for this sector. "Progress Microfinance", which is jointly funded by the EC and the European Investment Bank (EIB), consists of a guarantee instrument to microcredit organisations and a Fund offering senior loans, subordinated loans, risk-sharing loans and equity participation to microcredit providers (*http://ec.europa.eu/epmf*).

Equity finance

In contrast to debt, equity investors take shares in the businesses they invest in, providing them with some form of ownership. Larger investments tend to be made through the venture capital market, while smaller investments can be made by business angel investors or business partners. One of the advantages of equity over a loan is that the entrepreneur does not have to pay back regularly, even during periods when they are facing cash flow difficulties. Instead the equity investor earns dividends and can sell their stake reflecting the value of the enterprise at the time. Effectively, the equity investor participates in the gains when they occur, but loses some, or all, of their claim if the business goes badly.

There are some attitudinal barriers to the development of equity investment for business creation and development. In the minds of many entrepreneurs, investors and public business development agencies, equity investments are associated more with high-growth potential businesses than micro firms, while entrepreneurs often prefer not to take on equity investments in order to avoid ceding any control of their business. On the other hand, access to informal equity capital may provide a route to fund business creation and growth by disadvantaged and under-represented groups, particularly if they are starting a business with a strong growth objective. Here, financial education has a role to play. Training and advice for entrepreneurs can help to explain the role that external equity can play in the business and the different methods of accessing it.

Apart from attitudinal issues, another barrier to equity financing for disadvantaged and under-represented entrepreneurs is the difficulty of intermediation in terms of matching entrepreneurs requiring equity investments with investors such as business angels. The equity investor has to undertake a search for suitable proposals, which can be very difficult even if they have strong contacts in target communities. Public agencies can play a role in addressing this search and matching problem by developing databases and networks of investors and entrepreneurs.

An example is LINC Scotland in the UK (*www.lincscot.co.uk/*). Established in 1993 with support from the economic development agency Scottish Enterprise, LINC Scotland has contributed to making the Scottish business angel market one of the most vibrant in Europe (OECD, 2011). It is estimated that the total business angel activity in the UK was GBP 317.7 million (approximately EUR 358 million) in 2009/2010, of which GBP 50.5 million (approximately EUR 57 million) (slightly less than 16%) can be ascribed to business angels in Scotland (Mason and Harrison, 2011).

LINC Scotland's mission has traditionally been to match entrepreneurs with business angel investors, acting as facilitator more than investment adviser. More recently, in line with experience in the rest of the EU, it has encouraged the formation of investor clubs and syndicates. The rationale is that syndicates can assess and monitor business pitches better than individual investors. At one level, LINC Scotland has become an incubator of new business angel syndicates, providing know-how and operating support in their early stages. Today, LINC Scotland hosts 18 investor clubs and is working on launching 5 more.

Crowd funding

Crowd funding is a relatively new phenomenon with potential to become a major channel for nascent and existing entrepreneurs to access funding via the Internet. The technique uses on-line platforms to put entrepreneurs with business ideas in touch with many small investors, who may be members of the general public. By signing up to such platforms, individual investors can commit small amounts of funding, effectively spreading their risks across a number of projects. They select the projects they wish to invest in on the basis of project information placed on the platform by the entrepreneurs seeking investments. While most investment through such platforms is in the form of small loans, it is also possible to use the platforms for small equity investments.

Two factors make crowd funding particularly relevant to disadvantaged and under-represented entrepreneurs. First, through crowd funding, entrepreneurs bypass the traditional credit market where they may experience discrimination. By providing only the information that they are willing to disclose, the entrepreneur is less likely to experience discrimination related to age, gender, ethnicity or other personal characteristics. Nonetheless, the lower risk of noneconomic discrimination does not prevent other typical credit market failures which also affect crowd funding (e.g. information asymmetries, moral hazard, etc.).

Second, low intermediation costs can make crowd funding a cheaper source of finance than bank loans. Intermediation costs in crowd funding tend to be relatively low because the risk assessment and follow-up of the business proposals hosted by the Internet platforms are less thorough than for bank loans (given that the platforms do not carry the risk of the investment) and because, by using the Internet, fixed costs (e.g. staff, office space, etc.) are dropped.

Some degree of heterogeneity exists in the sector and some crowd funding platforms have gone as far as creating an on-line community that follows projects as they are developed, potentially providing other ideas, markets and support as well as second rounds of finance to the entrepreneurs.

The best known examples are in the United States, such as the Kickstarter platform (*www.kickstarter.com*). Kickstarter is a funding platform for creative projects including films, games, design, theatre productions, publications and new technology. Individuals

with new projects apply to Kickstarter to host their ideas, which may be illustrated with videos, written descriptions and pictorial representations. They then effectively "appeal" for funding using the platform which operates an "all or nothing policy". That is, if an individual project does not reach its funding goal, zero funds will be committed to it and the project is withdrawn.

There are also European examples of funding platforms using similar principles. The volume of capital managed by these platforms is rising rapidly, and their potential and importance has been boosted by the greater difficulties that entrepreneurs are facing in accessing traditional bank finance in the post global financial crisis climate. An example is the Funding Circle platform in the UK (*www.fundingcircle.com*). This is an online market place which claims to offer lower costs loans for businesses and higher returns for investors. It is sometimes described as a peer-to-peer platform (P2P) since it provides a platform for a direct investor-entrepreneur relationship. Another example is the German social lending platform Smava (*www.smava.de*). Smava claims to have doubled its loan volume from EUR 2.5 million in the second quarter of 2009 to EUR 5 million in the third and is reported as being more successful that an equivalent platform in the US, Prosper (*www.prosper.com*) (Techcrunch, 2009).

One of the key roles for policy in helping to exploit the opportunities of crowd funding for entrepreneurs from disadvantaged and under-represented groups is provision of information and advice about this financing mechanism to entrepreneurs in the target group. This is particularly important since crowd funding is a very new market and entrepreneurs are not always up-to-date with the latest evolutions in business finance. Investors, too, would benefit from help in understanding how they can use crowd funding platforms and how they can assess the merits and risks of different crowd funding pitches. Since much of crowd funding is driven by social considerations as well as simple profit considerations, advice should go beyond traditional concepts such as return on investment to give the right emphasis to the social impact of the business proposals being assessed.

Legislators also need to keep up with developments in crowd funding to ensure that the regulatory environment is favourable and provides sufficient investor protection. One of the problems that can arise with crowd funding platforms is low control by platform managers on the viability of business proposals put forward for investment and low monitoring of their progress. Similarly, information on business projects is limited to what entrepreneurs are willing to disclose, whereas more structured and homogenous information requirements would help investors make a better choice. Finally, the support of equity-based crowd funding should also encourage the parallel development of senior investors (e.g. business angels) and secondary markets to secure exit options for people investing in equity through crowd funding platforms.

Bootstrapping

Although the dangers of excessive reliance on internal funding have been pointed out earlier in the chapter, it is clearly also important that entrepreneurs recognise the opportunities they have for internal funding and use them appropriately and in a sustainable way, in combination with external finance. Bootstrapping is the name for a set of techniques that can be used to maximise the contribution of internal funding without leaving the business under-capitalised. The main methods are shown in Box 8.8, including minimisation of accounts receivable and joint utilisation.

Box 8.8. **Bootstrapping**

Bootstrapping can be defined as the use of internal finance sources to meet the resource needs of a business without relying on external finance (Winborg and Landström, 2000). While there is a great deal of policy emphasis on how policies can boost the supply of finance, businesses primarily draw on internal sources to finance their activities. In the United States, for example, as many as 95% of entrepreneurs use personal funds in the start-up phase and in nearly one-third of businesses personal contributions are the only source of financing (Gartner et al., 2008). It is therefore important also to help entrepreneurs consider how to make the most of their internal resources without jeopardising the development of their business.

Five different categories of bootstrapping are identified by the literature (Winborg and Landström, 2000; Jones and Jayawarna, 2010):

- Owner-financing methods (e.g. use of manager's credit card, loan from relatives and friends, withholding of the manager's salary, relatives working for non-market salaries).
- Minimisation of accounts receivable (e.g. cease business relations with late payers, use routines for speeding up invoices).
- Joint utilisation (e.g. borrow equipment, coordinate purchase with other entrepreneurs, barter instead of buying).
- Delaying payment (e.g. lease equipment and delay payment to suppliers).
- Minimisation of capital invested in stocks (e.g. use routines in order to minimise stocks, bargain best possible conditions with suppliers).

Most firms draw on bootstrapping because they are financially constrained, in which case they are more likely to use minimisation of accounts receivable and delayed payment methods to quickly solve cash flow issues (Ebben, 2009). However, the use of bootstrapping can also be a deliberate choice to reduce the risks and costs of business financing (Winborg, 2009) and both large and small firms use these techniques (Harrison et al., 2004).

There are some significant gender differences in the use of bootstrapping: males are more likely to use owner-financing and joint utilisation bootstrapping methods, possibly because of greater savings and larger networks than women, while women are more likely to use minimisation of accounts receivable thanks to a stronger tendency to manage their business through relationships with stakeholders (Neeley and Van Auken, 2009). Women-owned enterprises are also significantly more likely to draw on methods that reduce labour costs (Brush et al., 2006).

Another study looked at the use of bootstrapping methods among entrepreneurs that had received the New Entrepreneur Scholarship scheme in the UK (Jayawarna et al., 2011). This is a programme that provides individuals from deprived neighbourhoods a six-month training course to start a business. The results show that the individual's social networks were important for business performance. Those entrepreneurs who made use of their networks to bootstrap additional resources enhanced the performance of their business. The study also found that different bootstrapping methods had different impacts on business performance. Methods such as joint utilisation, minimisation of accounts receivable and delaying payment fuelled higher performance, whereas owner-financing bootstrapping was not linked to higher performance. Finally, programme recipients who

also received subsidised finance in the form of government grants or loans continued to use bootstrapping, indicating that bootstrapping can be a complementary source of finance and not only an alternative to external finance.

Overall, bootstrapping represents a set of useful techniques that business creators and owners from disadvantaged and under-represented groups can exploit to acquire complementary resources to external finance. Policy actions can favour bootstrapping in particular by providing financial education and guidance to entrepreneurs.

Policy actions to improve financing

Box 8.9. **Key policy messages – Policy actions to improve financing**

- Increasing awareness and information about finance sources among entrepreneurs and improving their ability to present their finance demands can increase external finance.
- Training, counselling, coaching and mentoring are all important in helping entrepreneurs to better manage their finances and should accompany financing offered.
- Financial intermediation can be improved by matching of investors and entrepreneurs and networking initiatives.
- Governments should review regulatory requirements for new finance sources such as crowd funding and mutual guarantees.
- Public loan guarantees and counter-guarantees are a key method for encouraging banks to expand their lending to disadvantaged and under-represented groups.

Brokerage, participation in capital of funds and subsidies for operational costs can be used to support the emergence of microfinance institutions and crowd funding platforms, together with promotion of competition and openness in the banking sector.

Policy interventions to improve access to financing among disadvantaged and under-represented groups can occur on several levels, as illustrated in Table 8.1; raising awareness, matching agents and creating networks, developing regulations, providing loan guarantees, and promoting the emergence of new financial institutions. At each level, a number of specific policy actions can be implemented, such as investment readiness programmes, financial regulation, credit guarantee schemes and the creation of microfinance institutions. The policy responses tend to involve increasing intensities of intervention according to the level, while some actions work principally on the demand side or on intermediation (levels 1 and 2) and others work largely on the supply side, in terms of increasing the volume of funds offered by existing institutions or creating new ones (levels 3, 4 and 5). A particular programme may act on a number of levels in this framework. For example, a microfinance programme could seek to raise awareness among entrepreneurs and potential entrepreneurs about finance options, improve the flow of information between investors and entrepreneurs with a networking programme, and seek to introduce new funds aimed at the target group.

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Table 8.1. **Potential policy actions to improve access to finance for inclusive entrepreneurship**

Level 1: Raise entrepreneurs' awareness of funding sources and requirements	1.1. Information on the range of finance sources available 1.2. Information on exploiting "new" sources such as crowd funding 1.3. Information on using techniques such as "bootstrapping" 1.4. Advice, training and coaching on finance sources and financial management 1.5. Investor-readiness programmes on "pitching" to investors
Level 2: Match and create networks	2.1. Promoting outreach by banks 2.2. Databases of angel investors and potential investees 2.3. Networking between entrepreneurs and investors 2.4. Networking among entrepreneurs, e.g. for mutual guarantees
Level 3: Develop regulation of new forms of finance	3.1. Better financial regulation, e.g. for crowd funding, mutual guarantees and microfinance 3.2. Promote competition in the banking sector
Level 4: Develop loan guarantee funds	4.1. Targeted loan guarantee schemes 4.2. Counter-guarantees for mutual guarantee programmes 4.3. Co-investment in funds 4.4. Support for operational costs of funds
Level 5: Encourage the emergence of new financial institutions	5.1. Support community banks 5.2. Support microfinance institutions 5.3. Support crowd funding platforms

Raising awareness and increasing investor readiness

A significant problem in access to funding by entrepreneurs from disadvantaged and under-represented groups is lack of awareness of the variety of funding opportunities available, together with lack of information about funder expectations and requirements and the discouraged borrower effect. Supplying information about financing opportunities to existing and potential entrepreneurs and self-employed people helps to respond to these problems. Basic, low cost information can be provided over the Internet, while training workshops and one-to-one advice and coaching can provide richer information more tailored to the circumstances of individual entrepreneurs. Entrepreneurs should also be supported with investor-readiness training and guidance focused on helping them to put forward more solid projects for funding and to make a better case for them. Financial education for entrepreneurs should be included as a key component of entrepreneurship skills development courses.

Matching and networking

Useful policy measures can also be developed to match investors with entrepreneurs requiring finance. For example, policy may develop networks of angel investors from particular target social groups, such as women or ethnic minorities, while measures that encourage the formation of networks among entrepreneurs can also underpin the successful development of mutual guarantee schemes.

Policy can also encourage traditional financial institutions to reach out more to clients from disadvantaged and under-represented groups in order to encourage them to apply for finance and to ensure that they are not discriminated against in terms of prejudices of loan officers or operational methods of the bank. For example, policy can encourage banks to issue guidelines and training for loan officers on dealing with disadvantaged and under-represented groups, recruit more loan staff from these communities, establish branch offices at the community level, and offer multilingual services for ethnic minority

customers. While it can be useful for banks to establish microfinance arms for outreach, it is also important that these operating features are adopted within the mainstream of bank activities.

Developing regulation of new forms of finance

Given the emergence of new forms of financing such as crowd funding and mutual guarantees, it is important for governments to review financial regulations in order to ensure that these markets are properly regulated to protect investors whilst ensuring that they do suffer from unnecessary barriers to entry.

In addition, reforms aimed at promoting competition and reducing concentration in the banking sector hold potential to reduce discrimination in the credit market and increase lending to under-represented and disadvantaged groups. Such actions should include reducing barriers to entry by microfinance institutions and crowd funding platforms in particular, but should extend to all types of finance supplier more generally.

Developing loan guarantee funds

One of the key levers that government can use for increasing the supply of financing to disadvantaged and under-represented groups is the offer of public credit guarantees to encourage banks to lend more to target communities, or counter guarantees to mutual guarantee schemes seeking to achieve the same end. Government can also play an important role in brokering the establishment of mutual guarantee schemes and contributing to their capital and operating costs.

Encouraging new financial institutions

Microfinance institutions play a key role in improving the access of under-represented and disadvantaged groups to finance. Thanks to their in-depth knowledge of a smaller base of customers, such institutions are more suited than large institutions for relationship lending, in which the loan decisions are based on personal knowledge and a continued relationship with the entrepreneur, thus helping to overcome problems faced by mainstream lenders in assessing risk. Policy can favour the emergence of microfinance institutions by brokering their creation or participating in their capital and operating costs.

Clearly, governments also need to consider how to further the potential of crowd funding as an additional finance source for disadvantaged and under-represented groups in entrepreneurship and self-employment.

Conclusions and policy recommendations

Access to finance is often reported by entrepreneurs as the most important obstacle they face in business start-up, and the barriers are even more pronounced for people from disadvantaged and under-represented groups. The additional challenges they face arise from discrimination, low levels of savings, low levels of financial literacy and a lack of, or poor, credit history. Among the consequences are likely to be the establishment of under-capitalised businesses, smaller scale businesses, and businesses focused on products and services with more limited capital requirements, while start-up activity by disadvantaged and under-represented groups is also likely to be hindered.

A number of alternatives to traditional bank loans are now emerging, including mutual guarantee schemes, equity finance, crowd funding and bootstrapping. It is important that

people from disadvantaged and under-represented groups have access to information about them together with appropriate advice and coaching on how to exploit them alongside traditional finance sources. At the same time policy actions can also work on improving financial intermediation using matching and networking initiatives, and encouraging better outreach by banks. Finally, policy can have an important role to play in increasing the supply of finance through targeted loan guarantees, contributions to the capital and operating costs of microfinance initiatives and strengthening competition and openness in the banking sector.

Based on these conclusions, the following policy recommendations are offered.

Key policy recommendations

- Provide information, advice and training to disadvantaged and under-represented entrepreneurs to raise their awareness of funding opportunities and requirements and improve their financial management.
- Work with banks to improve their communication lines and operating procedures with entrepreneurs from under-represented and disadvantaged groups.
- Support the development of targeted credit guarantees and mutual guarantee schemes.
- Promote the emergence of new microfinance institutions and crowd funding platforms targeted at entrepreneurs from disadvantaged and under-represented groups using brokerage, participation in capital and/or operating costs, and encouragement of competition and openness in the banking sector.

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