New Approaches to SME and Entrepreneurship Financing
Broadening the Range of Instruments
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Chapter 2

Traditional debt finance and alternative financing instruments for SMEs

This chapter provides the rationale for the study and illustrates the objective and structure of the report. It describes traditional lending technologies and related credit-risk mitigation techniques. It comments on their limitations for financing young and small firms and for sustaining long-term investment and growth. It discusses how financing instruments alternative to straight debt alter the traditional risk-sharing mechanism and proposes a categorization of these instruments across the risk/return spectrum, i.e. by differing degrees of risk and return.

SME finance in the post-crisis environment

Bank lending is the most common source of external finance for many SMEs and entrepreneurs, which are often heavily reliant on straight debt to fulfil their start-up, cash flow and investment needs. While it is commonly used by small businesses, however, traditional bank finance poses challenges to SMEs and may be ill-suited at specific stages in the firm life cycle.

In particular, debt financing appears to be ill-suited for newer, innovative and fast growing companies, with a higher risk-return profile. The "financing gap" that affects these businesses is often a "growth capital gap". Substantial amounts of funds might be needed to finance projects with high growth prospects, while the associated profit patterns are often difficult to forecast. The financing constraints can be especially severe in the case of start-ups or small businesses that rely on intangibles in their business model, as these are highly firm-specific and difficult to use as collateral in traditional debt relations (OECD, 2010a). Yet, for most enterprises, there are few alternatives to traditional debt (OECD, 2006). This represents an important challenge for policy makers pursuing sustainable recovery and long-term growth, since these companies are often at the forefront in job creation, the application of new technologies and the development of new business models.

While alternatives to traditional debt finance are particularly important for start-ups, high-growth and innovative SMEs, the development of alternative financing techniques may be relevant to the broader population of SMEs and micro-enterprises. Capital gaps exist also for companies seeking to effect important transitions in their activities, such as ownership and control changes, as well as for SMEs seeking to de-leverage and improve their capital structures. The thin capitalisation and excessive "leverage" (excessive reliance on debt financing compared to equity) impose costs, as loans to companies that already have considerable amounts of debt tend to have higher interest rates, and increase the risk of financial distress and bankruptcy.

In the aftermath of the 2008-09 global financial crisis, the bank credit constraints experienced by SMEs in many countries have further highlighted the vulnerability of the SME sector to changing conditions in bank lending. The long-standing need to strengthen capital structures and to decrease dependence on borrowing has now become more urgent, as many firms were obliged to increase leverage in order to survive the crisis, and, at the same time, banks in many OECD countries have been contracting their balance sheets in order to meet more rigorous prudential rules. As banks continue their deleveraging process, there is a risk that a large-scale reduction in bank assets could lead to a credit crunch (IMF, 2012a, 2012b). There is a broad concern that credit constraints will simply become "the new normal" for SMEs and entrepreneurs and that they could be disproportionately affected by the on-going financial reforms, and especially by the rapid pace of their implementation, as they are more dependent on bank finance than large firms and less able to adapt readily (OECD, 2012).

It is therefore necessary to broaden the range of financing instruments available to SMEs and entrepreneurs, in order to enable them to continue to play their role in growth,

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innovation and employment. Financial stability, financial inclusion and financial deepening should be considered as mutually reinforcing objectives in the quest for sustainable recovery and long-term growth. While bank financing will continue to be crucial for the SME sector, more diversified options for SME financing could support long-term investments and reduce the vulnerability of the sector to changes in the credit market. Indeed, the problem of SME over-leveraging may have been exacerbated by the policy responses to the financial crisis, as the emergency stabilisation programmes tended to focus on mechanisms that enabled firms to increase their debt (e.g. direct lending, loan guarantees), as funding from other sources (e.g. business angels, venture capital) became more scarce (OECD, 2010b, 2012).

An effective financial system is one that can supply financial resources to a broad range of companies in varying circumstances and channel financial wealth from different sources to business investments. As the banking sector remains weak and banks adjust to the new regulatory environment, institutional investors and other non-bank players, including wealthy private investors, have a potential role to play for filling the financing gap that may widen in the post-crisis environment.

However, a lack of awareness and understanding on the part of SMEs, financial institutions and governments of alternative financial instruments, their modalities and operations constitute a major barrier to their use. Through the present report, the OECD intends to help broaden the finance options available to SMEs and entrepreneurs, by improving understanding about the full range of financing instruments they can access in varying circumstances and by encouraging discussion among stakeholders about new approaches and innovative policies for SME and entrepreneurship financing.

For this purpose, the present report maps a broad range of financing techniques alternative to straight debt, providing insights about their functioning, the profile of firms that are suited for them, key enabling factors for their development, major trends in the market and access by SMEs, and policies to support a broader uptake by the SME population. The remainder of this chapter describes traditional lending technologies and related credit-risk mitigation techniques, comments on their limitations for financing young and small firms and for sustaining long-term investment and growth, and briefly introduces the main financial instruments alternative to straight debt, categorizing them across the risk/return spectrum.

Traditional debt finance

Traditional debt finance – bank loans, overdrafts, credit lines and the use of credit cards – is the most common source of external finance for many SMEs and entrepreneurs. The defining characteristic of straight debt instruments is that they represent an unconditional claim on the borrower, who must pay a specified amount of interest to creditors at fixed intervals, regardless of the financial condition of the company or the return on the investment. The interest rate may be fixed or adjusted periodically according to a reference rate. Straight debt does not include any features other than payment of interest and repayment of principal, i.e. it cannot be converted into another asset, and bank claims have high priority in cases of bankruptcy ("senior debt").

Traditional lending technologies

In traditional debt finance, the extension of the credit is primarily based on the overall creditworthiness of the firm and the lender considers the expected future cash flow of the firm as the primary source of repayment. However, the techniques to assess and monitor

the firm's creditworthiness, thus addressing the problem of information asymmetry between lender and borrower, may vary significantly. Different lending technologies combine different sources of information about the borrower, screening and underwriting procedures, structure of the loan contracts, monitoring strategies and mechanisms. The literature distinguishes *transaction lending*, based primarily on "hard" quantitative data, and *relationship lending*, largely based on "soft" qualitative information (e.g. Berger and Udell, 2002, 2006). Under the first category are: i) financial statement lending, which depends on the availability of informative and audited financial statements on the side of the borrower and thus applies to informationally transparent borrowers, and; ii) small business credit scoring, which, on the other hand, may be applied to informationally opaque SMEs, as much of the information concerns the personal history of the owner, rather than the enterprise (Box 2.1).

Box 2.1. **Straight debt finance: Transaction lending technologies**

Financial statement lending

Financial statement lending is based primarily on the strength of a borrower's financial position and implies availability of informative and reliable financial statements, such as audited statements prepared in accordance to widely accepted accounting standards. It is thus reserved for informationally transparent firms. The extension of the credit depends on a strong financial condition as reflected in the financial ratios calculated from these statements, such as current ratio (current assets over current liabilities), debt to equity ratio, gross profit percentage (gross profit over gross sales), return on assets (net income over total assets), and return on equity (net income over net worth).

Small business credit scoring

Small business credit scoring is based on the analysis of large amounts of historical data about the SME's owner as well as the firm. It may thus be applied to informationally opaque SMEs. The data are entered into a loan performance prediction model, which yields a score for the loan. The approach allows reduction in costs and time of granting a loan, greater consistency of credit evaluation and focus on difficult cases or large loan requests. The scoring method was first adopted in consumer lending, based on the large amounts of data readily available for banks on the performance of consumer credits and on the characteristics of borrowers. In the case of SME lending, however, the data needed to manage credits on a statistical basis may be available only to large banks, which are in fact the main adopters of credit scoring, or to smaller financial institutions that share or 'pool' data. There exist also credit reference agencies that provide credit scoring systems to banks which lack their own historical database. The credit scoring provided to banks by external agencies can cover both the business and the individuals in the business, based on their personal credit experience and rating.

Source: Berger and Udell (2006), DeYoung et al. (2010), OECD (2013b).

In the case of relationship lending, information is gathered directly by the loan officer through contact over time with the enterprise, the entrepreneur and the local community, and by observing the SMEs' performance on all dimensions of its banking relationship, including loan contracts, deposits and other financial products. The loan officer may often remain the proprietor of the soft information, as this may not be easily observed and verified by others. This gives rise to agency problems, which may be better addressed by

small banking organisations with few managerial layers and closer coordination between the management and loan officers (Berger and Udell, 2002; Stein, 2002). Also, small banks are often headquartered closer to potential relationship customers, reducing problems associated with transmitting soft information from loan officers to senior management. In fact, greater hierarchical and/or geographical distance between the information collecting agent and the loan approving officer may lead to less reliance on subjective information and more on objective information (Liberti and Mian, 2009).

Empirical studies support the argument that small banks may find it more convenient than large institutions to engage in relationship lending. For instance, based on a survey of SMEs' finance in Japan, Uchida (2011) finds that, in the screening process to grant loans to SMEs, smaller banks give more importance to the relationship factor, also using third-party information as a reference. Furthermore, smaller banks tend to place greater emphasis on the collateral value of borrowers than large banks, suggesting that small banks might need to insure their relationship lending through the requirement of collateral. Matching data on US small businesses, the banks that lend to them and the contract characteristics of loans, Berger and Black (2011) also find that small banks have a comparative advantage in relationship lending. However, they also suggest that this advantage may be strongest for lending to the largest firms, whereas in the case of smallest firms credit scoring is increasingly preferred.

It is often the case, however, that banks adopt a mix of lending techniques to evaluate the firm's creditworthiness and assess the credit risk. Investigating the choice of the lending technologies on a sample of SME loans in Japan, Uchida et al. (2006) find complementarity among technologies. In particular, financial statement lending and relationship lending are often used jointly. In a study on lending practices towards Italian manufacturing firms, Bartoli et al. (2010) also find the distinction between transaction lenders and relationship lenders to be rather blurred, as firms may obtain debt finance from the same bank through different lending technologies. This form of complementarity is found at both large and small banks, suggesting that transactions lending techniques, such as credit scoring, are used to "harden" – or codify – the soft information collected through relationship lending. However, the study also finds that the way soft information is embodied in the lending decision differs depending on the main approach used by the bank. In particular, soft information appears to raise (lower) the probability of credit rationing if the bank adopts mainly transaction (relationship) lending technologies. In other terms, banks that mainly use hard information to screen borrowers tend to use soft information as a mechanism for further discriminating loan applications.

Credit risk mitigation in traditional lending

Specific challenges limit traditional bank lending to SMEs. These are largely related to the greater difficulties that lenders encounter in assessing and monitoring SMEs relative to large firms (OECD, 2006, 2013b). First, *asymmetric information* is a more serious problem in SMEs than in larger firms. SMEs often do not produce audited financial statements that yield credible financial information and have no obligation to make public disclosure of their financial reports, although they are generally obliged to produce them and make them available to relevant authorities upon request. Furthermore, in smaller enterprises, the line of demarcation between the finances of the owner(s) and those of the business is usually blurred. Unlike established public companies, which are expected to observe standards of corporate governance with clearly defined roles for shareholders, managers

and stakeholders, SMEs tend to reflect the idiosyncrasies of their owners and their informal relationships with stakeholders. Hence, the entrepreneur has better access than the financier to information concerning the operation of the business and has considerable leeway in sharing such information with outsiders. The implications of asymmetries in information are made more severe by the large heterogeneity in the SME sector. SMEs are characterised by wider variance of profitability and growth than larger enterprises, and exhibit greater year-to-year volatility in earnings (OECD, 2006).

Second, *the principal/agent problem*, which is inherent in all financing operations, is particularly acute in the case of SMEs. Once financing is received, the entrepreneur may use funds in ways other than those for which it was intended. An entrepreneur might undertake excessively risky projects since all of the "upside" of the project belongs to the entrepreneur while a banker would prefer a less risky operation, even if profitability is less than under the riskier alternative. A large firm wishing to undertake a comparatively risky activity could select a different technique with appropriate formulas for sharing risk and reward, such as equity issuance, but the range of choice available to small firms is usually narrower (OECD, 2013a).

Financial institutions have developed several methods to mitigate the incidence of these challenges in SME lending. The main objective is to alter the risk-sharing mechanism in order to align incentives between lender and borrower.

Commonly used methods to manage SME credit risk include (OECD, 2013a):

i) Requests for high equity contributions by prospective borrowers

ii) Requirements for collateral. i.e. an asset of the borrower, the possessive right of which is provided to the lender in case of default

iii) Credit guarantees, whereby should the borrower default the guarantor compensates a pre-defined share of the outstanding loan

iv) Loan covenants, i.e. a condition imposed by the lender with which the borrower must comply in order to adhere to the terms in the loan agreement. Common loan covenants include:

   a) Hazard insurance/content insurance, under which the borrower is required to keep insurance coverage on the plant/equipment or inventory in order to safeguard against the catastrophic loss of collateral;

   b) Key-man life insurance, which insures the life of the indispensable owner or manager without whom the company could not continue. The lender usually gets an assignment of the policy;

   c) Requirements for payment of taxes/fees/licenses, whereby the borrower agrees to keep those expenses up to date. In fact, failure to pay would result in the assets of the company being encumbered by a lien (i.e. legal claim on property) from the government, which would take precedence to the one from the bank;

   d) Provision of financial information on the borrower and guarantor, whereby the borrower agrees to submit financial statements for the continuing assessment by the bank;

   e) Borrower prevented from taking specific actions without prior approval, such as: change in management or merger, demanding more loans, or distributing dividends.

In the post-crisis environment, it is recognised that bank financing will continue to be crucial for the SME sector and policy measures in many countries are still largely oriented

towards facilitating SMEs' access to debt finance. However, it is increasingly acknowledged that more diversified options for SME financing are needed, to address the generalised "growth capital gap", to support long-term investment, to reduce the vulnerability of SMEs to shocks in the credit market, and to cope with the changing regulatory environment and more rigorous prudential rules.

Alternative financing instruments

Traditional debt finance generates moderate returns for lenders and is therefore appropriate for low-to-moderate risk profiles. It typically sustains the ordinary activity and short-term needs of SMEs, generally characterised by stable cash flow, modest growth, tested business models, and access to collateral or guarantees.

Financing instruments alternative to straight debt alter this traditional risk-sharing mechanism. Table 2.1 provides a list of external financing techniques alternative to straight debt, categorised into four groups, characterised by differing degrees of risk and return, whose main features (modalities/operational characteristics, enabling factors, trends, support policies) will be outlined in detail in this report.

Table 2.1. **Alternative external financing techniques for SMEs and entrepreneurs**

Low risk/Return	Low risk/Return	Medium risk/Return	High risk/Return
Asset-based finance	**Alternative debt**	**"Hybrid" instruments**	**Equity instruments**
• Asset-based lending • Factoring • Purchase order finance • Warehouse receipts • Leasing	• Corporate bonds • Securitised debt • Covered bonds • Private placements • Crowdfunding (debt)	• Subordinated loans/bonds • Silent participations • Participating loans • Profit participation rights • Convertible bonds • Bonds with warrants • Mezzanine finance	• Private equity • Venture capital • Business angels • Specialised platforms for public listing of SMEs • Crowdfunding (equity)

Source: OECD (2013a).

At the one end of the risk/return spectrum are financing instruments that sustain the short and medium-to-long term financing needs of SMEs, but that rely on different mechanisms than traditional debt. This is the case of *asset-based finance*, such as *asset-based lending*, *factoring* and *leasing*, whereby a firm obtains cash, based not on its own credit standing, but on the value that a particular asset generates in the course of its business. The close relationship between the liquidation value of an asset and the amount borrowed, as well as the broad range of assets that can be used to access lending, are the key factors that distinguish asset-based lending from traditional secured or collateralised lending, in which the loan amount and conditions also depend on the overall assessment of the firm's credit worthiness. Furthermore, asset-based lending generally provides more flexible terms than conventional secured lending, often allowing for revolving funds; as advances are paid off, the borrower can secure additional funds backed by other assets (see Chapter 3).

Trade credit is also an important source of finance for many SMEs and start-ups, which can substitute or supplement short-term bank lending. This mainly consists of the extension of traditional credit instruments and credit-mitigation tools, such as loans and guarantees, to sustain import and export activities. Guarantees can take the form of letters of credit (L/C), which represent a bank obligation to pay, thereby reducing an export's payment risk on an importer/buyer.

Alternative forms of debt also exist, which can be considered "innovative" in the context of SME financing because they have had until now limited applicability to the SME sector. These alternative debt instruments include *corporate bonds*, *securitised debt* and *covered bonds*, in which investors in the capital markets, rather than banks, provide the financing for SMEs (see Chapter 4). While corporate bonds are direct instruments of debt finance for SMEs, securitisation and covered bonds represent "indirect" tools for supporting SME debt financing, in that the product issued to the firm is a loan. In particular, securitisation of SME debt allows banks to transfer their credit risk to the capital markets, as SME loans are sold to a specialised company, which creates a new security backed by the payments of SMEs. In this way, banks achieve capital relief and free up capacity for new loans to SMEs. Over the last decade, securitised debt has grown rapidly, although the financial crisis hit this market severely. On the other hand, few SMEs have succeeded in issuing corporate bonds, because of difficulties that small privately held companies have in meeting investor protection regulations and the high relative cost of bond issuance for small companies (OECD, 2013a).

At the other end of the risk/return spectrum are financing instruments that enable an investor to accept more risk in exchange for a higher return, and are expected to produce a better alignment of the interests of certain kinds of SMEs and the providers of finance. *Hybrid instruments*, such as mezzanine finance, form a bridge between traditional straight debt and pure equity (see Chapter 6). *Seed and early stage finance* addresses the high risk-return segment of the business financing spectrum, boosting firm creation and development, whereas other equity-related instruments, such as *private equity* and *specialised platforms for SME public listing*, can provide financial resources for growth-oriented SMEs (see Chapter 7).

The report also considers the potential for SME financing of new instruments, such as *crowdfunding* or *peer-to-peer lending*. These have grown rapidly in some countries and have attracted increasing attention by policy makers and regulators, also with a view to address concerns about transparency, investors' risk awareness and consumer protection (see Chapter 5).

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