

Entrepreneurship

IMPROVING SME FINANCING FOR STRONGER GROWTH AND JOB CREATION

- ▶ Seven years after the global financial crisis, lending to US small businesses is still below the pre-crisis levels and credit conditions remain tight for many of these firms.
- ▶ The accommodative policy of the Federal Reserve, the sharp decline in the delinquency rate for small businesses and the strong performance of corporate profits are contributing to a gradual recovery in credit.
- ▶ A more diversified set of options for SME financing should continue to be pursued to support long-term investment and reverse the trend decline in the number of start-ups.

What's the issue?

Access to finance represents a key challenge for firm creation and small business growth, which the financial crisis exacerbated in many countries. In the United States, despite recent robust economic growth, SME lending is only slowly recovering (see Figure). Demand- and supply-side factors, along with heightened regulatory oversight and increased reserve requirements in the banking sector, explain the sluggish recovery of SME lending. While credit conditions have recently improved, the decrease in the share of small firms taking out loans indicates that some SMEs have not re-entered credit markets.

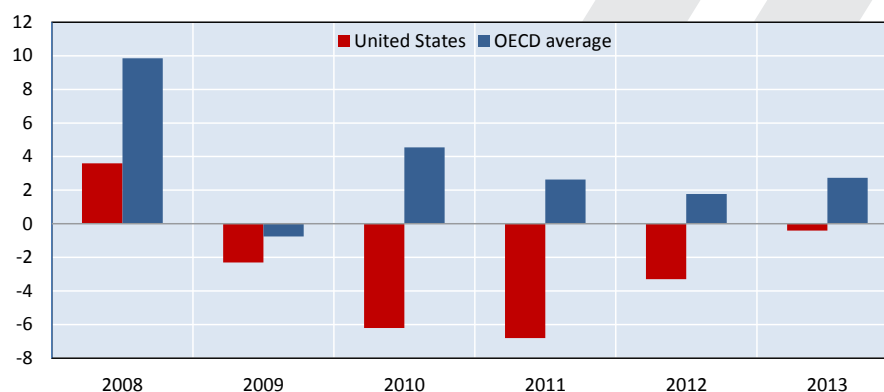
While bank financing will continue to be crucial for SMEs, a more diversified set of financing options is required to support long-term investment and foster new, innovative

and fast-growing firms. To encourage greater demand for alternative financing instruments, the government has expanded entrepreneurship training opportunities for underserved communities through a re-launch of the Emerging Leaders Programme, as well as by an increased partnership with market players. These are two very welcome steps.

Loans partially guaranteed by the US Small Business Administration (SBA) play a leading role – in 2013, the SBA provided a record number of USD 22.6 billion of guarantees to SMEs (3.9% of the total stock of outstanding loans to SMEs). Nevertheless, the number of guaranteed loans has remained relatively flat in recent years, especially for start-ups, underserved communities and small loans, suggesting that the loan guarantee

SME lending declined more in the United States than in other OECD countries

Year-on-year change in outstanding SME loans, in percent



Source: OECD (2015), *Financing SMEs and entrepreneurs 2015: An OECD Scoreboard*, OECD Publishing.

programme has become less effective in reaching the small businesses most cut off from credit markets. The SBA has taken several steps to address this challenge, such as eliminating lenders' fees for loan guarantees equalling or lower than USD 150 000 and paying the fees to obtain borrower credit score information for these loans, but further efforts are needed.

While capital markets for SMEs are relatively well-developed in the US, market and regulatory obstacles remain. Lack of comparable and timely credit information is a significant impediment to fostering market-based SME finance. The SBA has made progress in this area through its business credit score model. The credit risk assessment used by the SBA to pre-screen loans it insures will be made available to all its lending partners for loans of USD 350 000 or less through the so-called Lender Portal, which centralises the data collected. Moreover, regulatory initiatives requiring the provision of detailed, standardised loan-level information have been introduced, including the Wall Street Reform and Consumer Protection Act.

SME securitisation is relatively underdeveloped compared to other securitisation classes, such as the real estate and consumer market segments. The growth of some alternative instruments, such as crowdfunding, is limited by regulatory restrictions. Peer-to-peer lending is mainly used by households with the purpose of refinancing credit card debt and has not significantly expanded to businesses. Also, equity crowdfunding is not authorised in many states, and the Security and Exchange Commission's (SEC) rules to facilitate access to securities by small firms have not yet been implemented. The expanded exemption from SEC registration rules for "mini public offerings" adopted on 25 March 2015 is a welcome step that will help SMEs to better tap public equity markets.

Why is this important for the United States?

SMEs play a vital role in the economy of the United States, accounting for about 50% of private sector employment, paying 43% of the total private sector payroll, generating 64% of net new private sector jobs, and creating 46% of the private-sector output. SMEs and entrepreneurs have long been a driving force for wealth creation and continue to be incubators for innovation and employment growth during the current recovery. However, the lack of finance in appropriate forms seriously hampers entrepreneurs and SMEs in fulfilling their potential to innovate, grow and create jobs.

New firm creation has been on a trend decline for quite some time, with the Great Recession further adding to the problem. Net firm formation declined by 6.2% during 2008-11, more than fifteen times the 0.4% drop recorded during the steep 1991 recession. The bulk of the employment losses during the 2008-09 recession occurred in small firms, and the continuous downward trend in their labour turnover suggests that conservative behaviour persists among small firms.

What should policy makers do?

- ▶ Strengthen the SBA's efforts to encourage banks to provide small loans if the uptake of underserved businesses does not improve in 2015.
- ▶ Improve the information infrastructure for credit risk assessment, including collection of loan-level data and performance track records, and encourage ongoing reporting and data sharing...
- ▶ ...but safeguard an appropriate balance of the level of disclosure requirements to stimulate investor interest without rendering such issuance/investment overly costly or cumbersome.
- ▶ Use supply-side measures such as tax incentives, direct investment and co-investment, support to industry networks and associations to foster the development of a diversified portfolio of financing techniques available to SMEs.
- ▶ Swiftly implement the rules by the SEC to facilitate access to securities by small firms and support the development of equity investment, including investment crowdfunding.



Further reading

Nassr, I.K. and G. Wehinger (2015), "Unlocking SME Finance through Market-based Debt: Securitisation, Private Placements and Bonds", *OECD Journal: Financial Market Trends*. <http://dx.doi.org/10.1787/fmt-2014-5js3bg1g53ln>

OECD (2015), *Financing SMEs and Entrepreneurs 2015: An OECD Scoreboard*, OECD Publishing. https://dx.doi.org/10.1787/fin_sme_ent-2015-en

OECD (2015), *New Approaches to SME and Entrepreneurship Financing: Broadening the Range of Instruments*, OECD Publishing, forthcoming.