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Access to Finance for SMEs: In Search of Innovative Solutions Volume II

Follow-up of the FEE Round Table Access to Finance for SMEs – More Innovative Solutions, Tuesday 8 March 2011, 15.00 - 17.00 hrs CEST, FEE Offices.

All presentations and a short video can be accessed at:
http://www.fee.be/news/default.asp?content_ref=1346&library_ref=2

Introduction

Over the past two years, the SME Finance Fora have successfully broadened the debate on European small and medium sized businesses' (SMEs) access to finance and raised awareness of the wide range of options available to businesses. In the first of this series of papers, we also argued that acknowledging options beyond bank loans is crucial for the formulation of sound policies. On 8 March 2011 FEE invited experts to explore further those aspects of access to finance that are novel or under-represented in policy discourse and to debate three topics which were brought to the fore by the financial crisis of 2008-9 and its aftermath. These topics are the financing of green business, trade credit, and the emerging industry of peer to peer (P2P) finance.

Financing Green Business

Policymakers' commitment to a shift away from fossil fuels is embedded in the Commission's targets for 2020 and is a necessity if the effects of climate change are to be mitigated.[1] However, a great deal of path-dependence is embedded in the way people in Europe live, work and do business. Change will require persistent efforts, not a few well-aimed initiatives, and financing a sustained, EU-wide shift requires that significant amounts of money are directed at promising but unproven technologies; once supply chain investment is considered, these amounts dwarf even the Commission's current estimates.[2] Such business models are unlikely to be profitable or cash-positive from the outset, which means that substantial amounts of venture capital will be required for them to be thoroughly tested.

1 European Commission [EC] (2010b) Analysis of options to move beyond 20% greenhouse gas emissions and assessing the risk of carbon leakage http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:2010:0265:FIN:EN:PDF

2 EC (2010b); Green Investment Bank Commission (2010) Unlocking investment to deliver Britain's low carbon future. http://www.climatechangecapital.com/media/108890/unlocking%20investment%20to%20deliver%20britain's%20low%20carbon%20future%20-%20green%20investment%20bank%20commission%20report%20-%20final%20-%20june%202010.pdf

It is currently impossible for renewable energy to compete with ‘dirty’ fuels on a cost per kWh basis without extensive subsidies, not all of which will necessarily be justified by the negative externalities involved in using ‘dirty’ fuels.[3] Withdrawing the legacy subsidies attached to fossil fuels may have an equivalent effect. But perhaps just as important as the level of subsidy, is the consistency in its application: long-term investment of the type needed from both producers and, to some extent, consumers, will be difficult to sustain unless policy is consistent across a similar time horizon.[4]

Without secure profits or cashflow, the ability of innovative small companies and young industries with unproven concepts to attract funding will depend on early-stage finance by business angels and venture capitalists, including venture capital functions within large energy firms, and also to a significant extent on equity markets large and liquid enough to provide fair valuations. As venture capitalists increasingly seek more mature firms to invest in,[5] the role of educating entrepreneurs must inevitably fall to business advisers, including professional accountants.

SMEs, which account for a great deal of the environmental impact of industry in Europe,[6] are likely to require sustained support if they are to do their part in promoting Green growth, from state-funded business support to direct incentives and regulatory reform initiatives. Policy should explicitly consider the possibility that, without some level of subsidy, specific technologies may not break even during the lifecycle of the typical SME.

For SMEs some of the opportunities presented by the shift to a Green economy might lie with the production of green energy: smart grids in particular may make this a viable proposition. However, even greater potential is presented by the management of energy consumption, from waste prevention to smart metering and behavioural cues.[7] SMEs’ involvement in the Green economy will certainly be intellectual property (IP) - intensive. Strengthening IP protection and, more importantly, awareness could make it easier for promising firms to attract funding, while timely and credible commitment to EU-wide standards where possible should also ensure fair valuations for such innovations.

All of this change is being attempted against the background of a substantial skills gap in occupations relevant to the cleantech and renewables industries.[8] The implication is that, unless funding to address this is explicitly tied to EU and member-state funding for infrastructure and subsidies, the return on these substantial investments is likely to be reduced.

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3 Prins, G., et al. (2010), The Hartwell Paper – A New Direction for Climate Policy after the Crash of 2009 (London School of Economics and Political Science): http://eprints.lse.ac.uk/27939/1/HartwellPaper_English_version.pdf

4 See Couture, T. and Gagnion, Y. (2010) ‘An analysis of feed-in tariff remuneration models: Implications for renewable energy investment.’ Energy Policy 38:2, pp. 955-965: http://www.e3analytics.ca/documents/fitpolicy.pdf

5 EVCA (2010) Investments by stage – Evolution: http://www.evca.eu/uploadedFiles/Home/Knowledge_Center/EVCA_Research/Statistics/4_3_Investment/YB10_European_private_equity_investment_2005-2009.pdf

6 Calogirou, C., Sørensen, S. Y., Larsen, P.B., Pedersen, K., Kristiansen, K. R., Mogensen, J., Alexopoulou, S., & Papageorgiou, M. (2010) SMEs and the Environment in the European Union European Commission, http://ec.europa.eu/enterprise/policies/sme/business-environment/files/main_report_en.pdf

7 See for instance EPC Working Paper No.29 Gain without pain: towards a more rational use of energy: http://www.epc.eu/documents/uploads/657031332_EPC%20Working%20Paper%2029%20Gain%20without%20pain.pdf

8 CEDEFOP (2010) Skills for Green Growth: European Synthesis Report. Luxembourg: Publications Office of the European Union: http://www.ilo.org/wcmsp5/groups/public/---ed_emp/---ifp_skills/documents/publication/wcms_143855.pdf

Trade Credit and small business finance

The vast majority of business to business (B2B) transactions in Europe are made on credit, not cash.[9] This means that the most important source of short-term finance for SMEs are usually not banks but their suppliers; a finding which holds across nearly all developed and developing countries. When businesses wish or need to generate cash internally, they often end up paying their suppliers later than agreed or demanding discounts for prompt payment, especially if they have substantial bargaining power. Some troubled businesses end up never paying at all. The resulting cascade of cashflow stress and late payments creates serious challenges for small suppliers and is responsible for a great deal of business mortality. Despite this, smaller businesses generally use credit as a marketing tool or an implicit guarantee of quality and may therefore fail to challenge late payers for fear of jeopardising valuable commercial relationships.[10]

The EU institutions are of course fully aware of how problematic late payment is for SMEs, as demonstrated in the recently enacted Late Payment Directive. However, the late payment problem is only the tip of the trade credit iceberg: this informal financial market can in some countries be twice as large as its banking equivalent. Despite the fact that trade credit was at least as acutely affected by the 2008-9 financial crisis as bank lending, and is generally vulnerable to systemic disruption, relatively little attention has been paid to trade credit as a source of finance to SMEs.

Trade credit interacts extensively with the formal banking sector; for example businesses may act as financial intermediaries by using banks' funds to extend credit to businesses that the banks themselves would not; businesses may be able to do this either because they are better informed or because they have more control over their customers than lenders do. Banks in turns take cues from trade creditors, preferring not to lend to businesses that suppliers refuse to extend credit to.[11]

This is generally prudent behaviour and suggests that the conduct of lenders cannot be judged without benchmarking it to that of trade creditors. However it also leaves open the possibility that, when treated correctly, suppliers can help to finance credit constrained but sound and innovative businesses even in the presence of market imperfections in the banking sector.

9 European Commission (2009) Accompanying Document to the Proposal for a Directive of the European Parliament and the of Council on Combating Late Payment in Commercial Transactions: Impact Assessment Commission Staff Working Document, April http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=SEC:2009:0315:FIN:en:PDF

10 Demirgüç-Kunt, A. and Maksimovic, V. (2001) 'Firms as financial intermediaries: evidence from Trade Credit Data' Policy Research Working Paper #2696 #: http://www-wds.worldbank.org/servlet/WDSContentServer/WDSP/IB/2001/11/28/000094946_0111090402236/Rendered/PDF/multi0page.pdf

11 Demirgüç-Kunt and Maksimovic (2001)

One implication of the commercial nature of trade credit is that external regulation is unlikely to have a catalytic effect on late payment or SMEs' working capital needs. However, regulation can provide valuable tools (such as statutory interest) which can be used in order to build internal policies that support a sustainable flow of credit in and out of businesses. Only a comprehensive, proactive approach to credit management, coupled with easy access to credit information, can ensure that businesses, especially SMEs, provide credit to one another in a sustainable way. As SMEs' advisers of choice on financial management, professional accountants have an important role to play in encouraging clients to adopt sustainable credit policies.

Peer to Peer (P2P) Finance

Since the near-failure of the banking system in 2008 and throughout its difficult recovery, the combination of low interest rates, rising risk-aversion among providers of finance, and resurgence in enterprise activity have provided a supportive environment for the incubation of a new system of financing businesses: online P2P finance. As P2P funding typically comes directly from individuals, who provide loans to a diversified group of recipients, this type of funding promises to build a financial supply chain that is robust to the systemic risk seen in banking or elsewhere, and that could be more responsive to the non-financial values that resonate with EU citizens.

P2P business finance has been a natural extension of P2P lending for consumers, and has, in the past couple of years, been able to duplicate many of the benefits traditionally associated with online disintermediation, by improving the economics of deposit taking and lending in favour of both investors and businesses, improving customer satisfaction and –most importantly- keeping default or failure rates low. As a result, P2P lending has achieved substantial growth despite not being covered by the formal government deposit guarantees associated with conventional bank deposits For many Peer2Peer lenders risk exposure is reduced through spreading loans across a large number of borrowers, a practice that is made possible by highly automated administrative systems that can allocate, document and monitor loan and repayment transactions at very low cost.

Already a wide range of financial products is available through online P2P platforms, including loans, equity investment and factoring, as well as products that blur the line between charitable or friendly giving and formal finance, such as crowdfunding.

This is important because a strong percentage of enterprise activity in Europe is driven by, and actively involves, the pursuit of social objectives – and will thus produce chiefly public benefits that do not accrue to the providers of capital.[12] For-profit credit provision still appears to be the dominant model, with non-profit funding and equity investment, in that order, slowly catching up.

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12 Bosma, N. and Levie, J. (2010), Global Entrepreneurship Monitor: 2009 Executive Report: http://www.gemconsortium.org/download.asp?fid=1055

Despite early successes this industry is still in its infancy. The regulatory and policy framework surrounding it is far from harmonised across member-states, even though guidelines on microfinance exist that could potentially offer a template for common rules.[13] Crucially, the relationship between P2P finance and traditional banking, venture capital and charity sectors is still unclear, although there may be a commercial case for banks to incorporate P2P platforms in their business models. At the European Institutions level, the Commission needs to take stock of best practices in encouraging and regulating this nascent industry, and member-states should consider whether there is room for tax incentives, already fairly established for informal equity financing, to be extended to P2P investing or P2P lending that does not attract a deposit guarantee.

The true potential of P2P finance to encourage enterprise and combat financial exclusion is still being explored. Social networks allow providers of finance to leverage an unprecedented volume and depth of personal information on entrepreneurs and company directors in order to perform due diligence. They also provide a new range of social controls similar to those implicated in the early success of microfinance initiatives which may help further reduce defaults or failure rates.[14] They even allow lenders to circumvent a bank's conventional divide between business and personal lending and thus achieve higher levels of information and security. These developments and their implications must be considered carefully by the industry, by regulators and by policymakers, so that the risks and benefits can be managed appropriately.

13 Basel Committee on Banking Supervision (2010) Microfinance activities and the core principles of banking supervision. Bank of International Settlements [BIS], August: http://www.bis.org/publ/bcbs175.pdf

14 See for instance Iyer, R., Khwaja, A. I., Luttmer, E. F. P., and Shue, K. (2010) 'Inferring Asset Quality: Determining Borrower Creditworthiness in Peer-to-peer Lending Markets' NBER Working Paper 15242, July: http://www.nber.org/~luttmer/peerlending.pdf

CONCLUSIONS

It is, at first glance, hard to imagine what the three issues discussed here have in common. However, all three lie at the interface between sustainable business practices and access to finance, and amongst their complexity the following themes emerge:

- Making SME finance more sustainable requires that policymakers think in the long-term: this involves changes in deeply-ingrained behaviour and requires certainty of direction. Consistent and persistently applied internal policies, external regulations, policy frameworks and subsidy schemes are therefore essential to the cause of sustainable finance.

- Sustainable SME finance involves a much wider range of stakeholders than the current agenda. It acknowledges positive and negative externalities and considers the importance of individual and commercial incentives and controls beyond considerations of risk and (financial) return for all involved.

- Good practice in informal SME finance cannot be mandated by regulation alone as it is an optimal solution to a complex web of relationships – some collegial (e.g. P2P funding), some commercial (trade credit within mutually satisfactory terms) and some adversarial. Regulation should instead seek to provide tools for SMEs and other stakeholders to manage these in order to smooth out imperfections in the formal and informal markets for finance and to address market failures.

- To improve the supply of SME finance, policymakers, finance providers and businesses must explore the use of types and sources of information that have so far remained underutilised, in order to improve due diligence and control.

Improving access to a wider range of SME finance requires substantial re-education for entrepreneurs and business owners, and a robust advice and business support offering. While governments and the EU institutions have their role to play, trusted advisers such as accountants need to live up to their responsibilities too.

About FEE

FEE (Fédération des Experts comptables Européens - Federation of European Accountants) represents 45 professional institutes of accountants and auditors from 33 European countries, including all 27 EU Member States.

In representing the profession, FEE recognises the public interest. FEE has a combined membership of more than 500.000 professional accountants working in different capacities in public practice, small and larger firms, business, public sector and education, who all contribute to a more efficient, transparent, and sustainable European economy. To learn more about FEE and about the accountancy profession in Europe, read the FEE 2008 Annual Review, downloadable from our website (www.fee.be).