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Financing Mechanisms to Support MSME and Startups: Role of the Capital Market

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ABSTRACT

The Micro, Small and Medium Enterprise (MSME) sector plays a significant role in the Indian economy. A catalyst for socio-economic transformation of the country, the sector is critical in meeting the national objectives of generating employment, reducing poverty, and discouraging rural-urban migration. These enterprises help to build a thriving entrepreneurial eco-system, in addition to promoting the use of indigenous technologies. The sector has exhibited consistent growth over the last few years, but it has done so in a constrained environment often resulting in inefficient resource utilization. Of the many challenges impeding the growth and development of MSMEs, inadequate access to financial resources is one of the key bottlenecks that make these enterprises vulnerable, particularly in periods of economic downturn. MSME sector is currently opening up in India to support startup initiatives, especially in the manufacturing, infrastructure and IT-enabled Services sector. The Government is fully committed now to extend whole-hearted financial and technical cooperation and support to the entrepreneurs to see through a boom in the Start-up industries; as also to fulfil the 'Make in India' Mission of the Government. Among other things, the major objectives of this Mission are to enhance the overall economic growth and create enormous job opportunities in India. The paper attempts to highlight the various financing mechanisms to support MSMEs and Startup initiatives in India and the Asia-Pacific Region with focus on the role of the Capital market.

Keywords: MSMEs; Startups; Financing Mechanisms; Capital Market.

1.0 Introduction

Definitions of SMEs often vary by country and are usually based on the number of employees, the annual turnover or the value of assets of enterprises. Typically, microenterprises are defined as enterprises with up to ten employees, small enterprises as those that have ten to 100 employees, and medium-sized enterprises as those with 100 to 250 employees. Unless otherwise specified, the definition of an SME that is used in this report is any enterprise with fewer than 250 employees.

This includes all types of enterprises, irrespective of their legal form (such as family enterprises, sole proprietorships or cooperatives) or whether they are formal or informal enterprises. For the sake of readability, the report uses the term SME throughout, unless a differentiation of sub-segments is needed. The term 'MSME' is widely used to describe small businesses in the private sector. Regulators and financial institutions across the world

use parameters such as employee strength, annual sales, value of fixed assets, and loan size proxies to define the sector in the context of finance. According to the World Bank definition, a business is classified as MSME when it meets two of the three criteria – employee strength, size of assets, or annual sales (Table 1).

Table 1: World Bank Definition of MSME

Enterprise Size	Employee	Assets	Annual Sales
Medium	<300	≤ USD 15 Million (≤ INR 750 Million)	≤ USD 15 Million (≤ INR 750 Million)
Small	<50	≤ USD 3 Million (≤ INR 150 Million)	≤ USD 3 Million (≤ INR 150 Million)
Micro	<10	≤ USD 10,000 (≤ INR 500,000)	≤ USD 10,000 (≤ INR 500,000)

Source: World Bank

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The Micro, Small and Medium Enterprise Development Act 2006 (MSMED Act) of the Government of India provides the definition of the MSME sector.

An extension of the erstwhile definition of Small Scale Industry (SSI), this classification uses the investment metric (Table 2) to define MSMEs because investment in plant and machinery can be measured and verified. The MSMED Act broadly segments the MSME sector in the following manner:

Table 2: MSMED Act Definition of MSME

Initial Investment in Plant and Machinery (in INR Million)*			
Category/ Enterprise Size	Micro	Small	Medium
Manufacturing	<2.5 (<50,000)	2.5 – 50 (50,000 – 1 Million)	50– 100 (1 Million – 2 Million)
Services	<1 (<20,000)	1 – 20 (20,000 – 0.4 Million)	20– 50 (0.4 Million – 1 Million)

*Figures in brackets are in USD; Source: MSMED Act

2.0 Financial Institutions and Definition of MSME and Startups

Although investments in plant and machinery are tangible and measurable, the current definition provides limited information on the financial appetite and financial performance of an enterprise.

As a result, many financial institutions prefer using annual sales/revenue (turnover) to segment and target MSMEs (Table 3), and as a key parameter for product development and risk management.

Table 3 outlines some broad parameters used by most of the financial institutions in India to define and segment the MSME sector for internal portfolio management purposes.

However, all institutions use the official definition provided by the MSMED Act for reporting purposes to the regulator.

Table 3: Internal Definitions Used by Private Financial Institutions (Indicative)

Internal Definitions used by Banks for MSME						
Enterprise Size	Micro		Small		Medium	
Institution Type	Turnover (INR Million)	Credit Size (INR Million)	Turnover (INR Million)	Credit Size (INR Million)	Turnover (INR Million)	Credit Size (INR Million)
Private Commercial Banks	1.5 – 50 (30,000 – 1 Million)	0.2 – 1 (4,000 – 20,000)	50 – 200 (1 Million – 4 Million)	5 – 150 (0.1 Million – 3 Million)	200 – 2000 (4 Million – 40 Million)	50 – 200 (1 Million – 4 Million)
Non-Banking Finance Companies	0.05 – 1 (1,000 – 20,000)	1 – 5 (20,000 – 0.1 Million)	5 – 25 (0.1 Million – 0.5 Million)	0.3 – 5 (6,000 – 0.1 Million)	10 – 1000 (0.2 Million – 20 Million)	2.5 – 50 (50,000 – 1 Million)

*Figures in brackets are in USD; Source: Primary Research

A startup company or startup or start-up is an entrepreneurial venture or a new business in the form of a company, a partnership or temporary organization designed to search for a repeatable and scalable business model. These companies, generally newly created, are innovation in a process of development, validation and research for target markets. The term became popular internationally during the dot-com bubble when a great number of dot-com companies were founded. Due to this background, many consider startups to be only tech companies, but this is not always true: the essence of startups has more to do with high ambition, innovativeness, scalability and growth. A startup is a company designed to grow fast. Being newly founded does not in itself make a company a startup. Nor is it necessary for a startup to work on technology, or take venture funding, or have some sort of "exit". The only essential thing is growth.

The value of a startup firm rests entirely on its future growth potential. This definition, among other things, emphasizes the stage of development rather than the structure of the company or its respective industry. Consequently, one may attribute certain characteristics to a startup which include, but are not limited to, its lack of history and past financial statements, its dependency on private equity, and its statistically small rate of survival.

3.0 Economic Contribution of MSME

It is important to note that in addition to helping catalyze the growth of the economy, MSMEs feed large local and international value chains as well as local consumer markets as suppliers, manufacturers, contractors, distributors, retailers and service providers. They account for a large share of industrial units, and contribute significantly to employment in the country (Table 4).

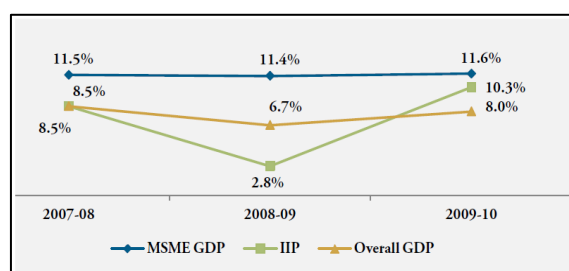
Table 4: Key Statistics on Economic Contribution of MSME

Key Metrics	
Share of	Value
Industrial units	95%
Industrial output	45%
Exports (in value)	40%
Gross Domestic Product (GDP)	~8%
Employment (in Millions)	69

Source: Ministry of MSME, Annual Report, 2009-10; RBI

Growing at 11.5 percent a year, the MSME sector has been performing better than the overall GDP (8 percent growth per annum) and overall industrial output (measured by Index of Industrial Production-IIP) (Figure 1). Current estimates of MSME contribution to GDP do not take into consideration the contribution made by unorganized private enterprises, for which asset and sales data is not tracked by government agencies.

Fig 1: Growth of MSME Sector vs. Growth in GDP and IIP



Source: Ministry of MSME, Annual Report, 2009-10

MSMEs are also effective vehicles for employment generation. India's cities have been experiencing the burden of a consistently growing population, comprising an ever – increasing proportion of migrants in search of employment and livelihood. With adequate financial and non-financial resources, as well as capacity-building, the MSME sector can grow and contribute to economic development considerably higher than it is doing currently.

4.0 Share of MSME in the Economy

There are approximately 46 million Micro, Small and Medium Enterprise sector enterprises across various industries, employing 106 million people (MSME Annual Report 2013). Overall, the MSME sector accounts for 45 percent of Indian industrial output and 40 percent of exports⁶.

While most of the sector is un-organised (approximately 94 per cent), informal and un-registered, initiatives to have more enterprises registered are well underway.

The contribution of the MSME sector to India's GDP currently stands at ~8 per cent for 2011-12, and is growing at a rate higher than the projected GDP growth rate. The contribution of MSME segment to the GDP in some of the global economies is in the 25-60 per cent range.

MSME in India has the potential to increase the share of contribution to GDP from the current 8 per cent to about 15 per cent by the year 2020.

5.0 MSME Landscape in India

In 2009-10, the Indian MSME sector was estimated to include 29.8 Million enterprises. In order to encourage these unorganized units to register, the Ministry of MSME has simplified the registration process.

The sector has been growing at an effective rate of 4 percent annually over the last three years from 2008-10 (Table 5).

The share of registered enterprises in the sector is estimated to be only around 6 percent, which goes to show that the sector is dominated by unregistered enterprises that do not file business information with District Industry Centers (DICs) of the State/ Union Territory.

Table 5: Size of the MSME Sector in India (in Millions)

Year	Registered	Unregistered	Total units
2006-07	1.5 (-6%)	24.6 (-94%)	26.1
2009-10	1.8 (-6%)	28.0 (-94%)	29.8

Source: MSME Census, Ministry of MSME, Annual Report, 2009-10

Micro, Small and Medium Enterprises (MSMEs) contribute nearly 8 percent of the country's GDP, 45 percent of the manufacturing output and 40 percent of the exports. They provide the largest share of employment after agriculture. They are the nurseries for entrepreneurship and innovation. They are widely dispersed across the country and produce a diverse range of products to meet the needs of the local markets, the global market and the national and international value chains.

6.0 MSME's Access to Financial Services

Providing access to appropriate financial services is a key element in establishing small-scale enterprise clusters in rural areas. While the development of microfinance institutions (MFIs) has increased the scope of financing possibilities for entrepreneurial activities, lending to small-scale entrepreneurs is often constrained by lack of resources.

In most countries, MFI lending resources derive from savings and current account deposits. The high cost of mobilizing small savings, and the need to adhere to official regulations, means that rural-based MFIs are mainly involved in providing short-term/working capital loans at high interest rates to cover their operational costs. Such high interest rates are not usually appropriate for small enterprise activities, which may require larger investments and longer amortization periods.

It may be possible to overcome the shortage of resources for lending to small rural enterprises by increasing cooperation between commercial banks – including development banks – and the microfinance sector.

In some developing countries, the forging of partnerships between commercial banks and MFIs is now being facilitated through institutionalization of the microfinance sector. Collaboration between MFIs and commercial/development banks may also be encouraged by guarantee mechanisms aimed at mobilizing resources for MSME development, for example.

It may also be possible to increase the access of poor entrepreneurs, especially women, to financial services by developing financial innovations targeted at MSMEs.

In this respect, leasing finance and/or self-help guarantee schemes may be more appropriate for RMSE financing if the venture/equity capital appears to be at risk owing to lack of legal status.

6.1. Access to non-financial services

Lessons learned with regard to modalities for developing micro, small and medium-scale enterprises in developing and emerging countries, as promoted by the Donor Committee on Small and Medium Enterprise, have led to the adoption of a 'double dimension' terminology.

If improved access of potential entrepreneurs to financial services represents the 'first dimension', access to non-financial services therefore represents the second. Non-financial services generally involve the following services/activities (non-exclusive list):

- entrepreneurship training, e.g. building up knowledge on elementary business principles and practices;
- business management, accounting and bookkeeping services, e.g. cash flow management, and improving the capacity of small-scale entrepreneurs to run their business activities over the long term;
- market services, e.g. market investigations (studies), training and facilitation (links with traders);
- access to cost-effective technologies and vocational/technology training;

- business planning, e.g. analysis of investment proposals, especially term-finance proposals, appraising their technical and financial feasibility and linking up with financial institutions for funding requirements; and
- Product and process quality assessment (quality standard requirements).

7.0 Routes of Alternative Finances for the MSMEs and the Startups

Improving access to community/cooperative finance for MSMEs, especially in their initial investment and the infusion of equity among its stakeholders could be a healthy way for MSMEs to tap in to its growth and innovative potential. However, a large number of MSMEs may face an equity gap. When their initial funds will be exhausted, entrepreneurs have to obtain external finance to develop their project. Financing MSME is, often considered a risky investment on account of the low rates of return; specifically during the seed phase. In India, lack of serious business analysis another dampening factor which otherwise could invest in young innovative MSMEs. The inability to obtain early stage investment narrows down many MSMEs reaching a size; where they can attract expansion capital, this restraint their growth. Despite these serious odds, MSMEs as sources of innovation and employment generation can be the catalyst of India's growth. So giving them the opportunity to start up, develop and accomplish their potential outcome will make a vital contribution to the quest of Indian economy.

Theists with Innovation: In last few years, obsessions for giant monolith businesses have lowered in India, which is encouraging for economy size businesses. Overreaching effects of this transcendence is visible in many crucial areas, so naturally financing also poisoning for twists with innovations. Complexities of institutional finances, particularly flawed handling of priority sector lending (PSL) by most of the Indian banks except Regional Rural banks, necessitate for MSMEs to also look on alternative sources of finance. On existing networks of cooperative institutions, a sizable number of farming based small and medium businesses have been thriving, here a think for more professionalization in these activities can let an

unprecedented opportunities to the aspiring SMEs. First of all, there is need for overhauling of regulatory structure in Cooperative institutions, besides increasing focus on improving the governance inside its functional ambit.

Community Participation: In its working mechanism, cooperative action relies on community participation. An individual considered here a constituent of community and a stakeholder of collective action directed for productive enterprises. It's true, cooperative movements have never touched its true potential in India because of inside malfunctioning and political interference in its administration albeit this will be still unthinkable to denounce its intrinsic qualities. Stable and inclusive motives of its action simply endow cooperative action to broaden the community based businesses. In more than hundred years of its history in India, Co-operative businesses have performed very well in the states of Gujarat, Maharashtra and also once in states of U.P. and Bihar. After all, who can forget that AMUL had started as SME in Anand/Gujarat, under the able leadership of Varghese Curion and all credit of this success goes to this man who trusted and dared for an out of box thinking by relying upon the local communities for production/financing under the umbrella of co-operative. Today AMUL is the most profound assertion of community lead business in a lover the world; time is ripe now to move forward with the similar replications. SMEs have golden opportunities to revive a symbiotic working relation with Co-operative institutions to tap its real potential.

Proven Routes: At initial level, concentration of capital would be in fact low or near about the optimum level which will need a frugal management practices for SMEs to make their way forward in limited resources. But the positive factor will be the member/stakeholders very close entitlement with the venture.

That means, sharing of common interest will be a unique characteristic of this model and will smoothly allow a sustainable business. Such business model on social/community action is not unheard of in India, only it needs a new pattern of execution and diversity in its expansion from primary sector businesses to secondary and tertiary as well.

Community Business: Beyond the formal mode of financing, community business seems the most appropriate option for SMEs in India. As we cannot expect SMEs being funded with endowments

like the Ivy League institutions of U.S. or the public funding of BBC in U.K., so equity based community model will be the best suitable route for Small and Medium Businesses (SMB) to attain their genuine goal. In India, community lead businesses have striking similarities with the Co-operative enterprises that obviously accord reliable and proven routes for SMEs to get financed and dwell with a stable model capable of giving long term feasibility in business.

A business with sound prospects must be given a fair chance. Adequate remodeling of the existing Co-operative laws and improving professional governance will allow SMEs a sound alternative of financing and will also give a much needed lease to the dwindling co-operative institutions. Excessive idealism or extreme hardening of profit motives is equally bad for a business. SMEs are increasingly doing well in India but their real potential will be realized once they will get the multiple channel of financing. Government and industry bodies must have to come forward in this very crucial issue.

The Venture Capital Sector is the most vibrant industry in the financial market today. Venture capitalists are professional investors who specialize in funding and building young, innovative enterprises. Venture capitalists are long-term investors who take a hands-on approach with all of their investments and actively work with entrepreneurial management teams in order to build great companies which will have the potential to develop into significant economic contributors.

Venture capital is an important source of equity for start-up companies. Venture capital can be visualized as —your ideas and our money concept of developing business.

Venture capitalists are people who pool financial resources from high net worth individuals, corporate, pension funds, insurance companies, etc. to invest in high risk - high return ventures that are unable to source funds from regular channels like banks and capital markets.

The venture capital industry in India has really taken off in. Venture capitalists not only provide monetary resources but also help the entrepreneur with guidance in formalizing his ideas into a viable business venture. Five critical success factors have been identified for the growth of VC in India, namely:

- The regulatory, tax and legal environment should play an enabling role as internationally venture funds have evolved in an atmosphere of structural flexibility, fiscal neutrality and operational adaptability.
- Resource raising, investment, management and exit should be as simple and flexible as needed and driven by global trends.
- Venture capital should become an institutionalized industry that protects investors and invitee firms, operating in an environment suitable for raising the large amounts of risk capital needed and for spurring innovation through start-up firms in a wide range of high growth areas.
- Venture capital should become an institutionalized industry that protects investors and invitee firms, operating in an environment suitable for raising the large amounts of risk capital needed and for spurring innovation through start-up firms in a wide range of high growth areas.
- In view of increasing global integration and mobility of capital it is important that Indian venture capital funds as well as venture finance enterprises are able to have global exposure and investment opportunities
- Infrastructure in the form of incubators and R&D need to be promoted using government support and private management as has successfully been done by countries such as the US, Israel and Taiwan. This is necessary for faster conversion of R&D and technological innovation into commercial products.
- With technology and knowledge based ideas set to drive the global economy in the coming millennium, and given the inherent strength by way of its human capital, technical skills, cost competitive workforce, research and entrepreneurship, India can unleash a revolution of wealth creation and rapid economic growth in a sustainable manner. However, for this to happen, there is a need for risk finance and venture capital environment which can leverage innovation, promote technology and harness knowledge based ideas.

7.1. Venture capital for the startups at a take-off stage in India

The venture capital industry in India is still at a nascent stage. With a view to promote innovation, enterprise and conversion of scientific technology and knowledge based ideas into commercial production, it is very important to promote venture capital activity in India. India's recent success story in the area of information technology has shown that there is a tremendous potential for growth of knowledge based industries. This potential is not only confined to information technology but is equally relevant in several areas such as bio-technology, pharmaceuticals and drugs, agriculture, food processing, telecommunications, services, etc. Given the inherent strength by way of its skilled and cost competitive manpower, technology, research and entrepreneurship, with proper environment and policy support, India can achieve rapid economic growth and competitive global strength in a sustainable manner.

A flourishing venture capital industry in India will fill the gap between the capital requirements of Manufacture and Service based startup enterprises and funding available from traditional institutional lenders such as banks. The gap exists because such startups are necessarily based on intangible assets such as human capital and on a technology-enabled mission, often with the hope of changing the world. Very often, they use technology developed in university and government research laboratories that would otherwise not be converted to commercial use. However, from the viewpoint of a traditional banker, they have neither physical assets nor a low-risk business plan. Not surprisingly, companies such as Apple, Exodus, Hotmail and Yahoo, to mention a few of the many successful multinational venture-capital funded companies, initially failed to get capital as startups when they approached traditional lenders. However, they were able to obtain finance from independently managed venture capital funds that focus on equity or equity-linked investments in privately held, high-growth companies. Along with this finance came smart advice, hand-on management support and other skills that helped the entrepreneurial vision to be converted to marketable products.

A similar investor preference for start-up IT companies is being seen, though not of the same magnitude. Yet, it is apparent that investors are

willing to take higher risks for a potentially higher reward by investing in start-up companies. Until 1998, the venture creation phenomenon for the IT sector in India had been quite unsatisfactory. Some experts believe that India lacks strong anchor companies like HP and Fairchild, which funded the start-ups of early Silicon Valley entrepreneurs. The venture capital phenomenon has now reached a take-off stage in India. Risk capital in all forms is becoming available more freely. As against the earlier trend, where it was easy to raise only growth capital, even financing of ideas or seed capital is available now. The number of players offering growth capital and the number of investors is rising rapidly. The successful IPOs of entrepreneur-driven Indian IT companies have had a very positive effect in attracting investors. The Indian government initiatives in formulating policies regarding sweat equity, stock options, tax breaks for venture capital along with overseas listings have all contributed to the enthusiasm among investors and entrepreneurs, as has the creation of the dot.com phenomenon. In India, the venture capital creation process has started taking off. All the four stages - including idea generation, start-up, growth ramp-up and exit processes - are being encouraged. However, much needs to be done in all of these areas, especially on the exit side.

8.0 Principal Sources of SMEs Financing in Relation to SMEs' Financing Life-Cycle

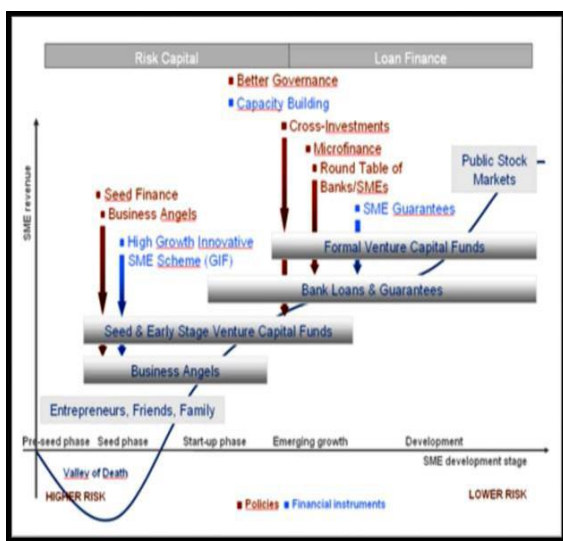
The source and the availability of financing for an SME are seen as the major factors behind its development, growth and success (Cook, 2001). The financial needs and the financing options open to SMEs vary depending on the stage in a firm's lifecycle. The access an SME has to capital depends on a number of factors, such as its level of development, the availability of finance in its jurisdiction, the nature of its business and its marketing capabilities, and the professional connections of the entrepreneur in charge.

The level and the type of demand for financing throughout an SME's life cycle depends on its stage of growth, as each stage requires a different financing strategy (Abdulsaleh & Worthington, 2013). This approach enables the business to grow and reach the capital markets, where it can raise long-term financing and sustain its growth. The literature on the life cycle financing for SMEs indicated that SMEs

should apply a holistic approach by using specific and different financing vehicles during their life cycle, as this leads to growth and survival. The life cycle financing approach cannot be applied to every small business; however, based on theory and empirical evidence, SMEs that adopt this approach reaped the benefits. The types of financing sources that are used on average by SMEs during their life cycle include: internal equity finance, represented by owner-manager personal savings, internally generated profits; venture capital; external equity, i.e. business angels; debt financing, e.g. mezzanine; trade credit; bank funding; and securities market (Ou & Haynes, 2006).

The above mentioned financing options produce benefits provided that they are used in the appropriate stages of the SME's life cycle (Figure 2). The stages that exist within the life cycle of an SME, as depicted in the graph below (for example) include seed-stage, start-up stage, emerging stage and expansion / development stage.

Fig 2: The SMES Life Cycle and Financing Needs



Source: DG Enterprise, 2007

The graph demonstrates a funding escalator that depicts the type of financing required at each stage of an SME life cycle as it grows or transitions.

- At the start of a small business or during the seed stage, personal savings of entrepreneurs, family and friends, as well as second mortgages on property are often the most important sources of financing, as these firms tend to be highly risky with intangible assets, a lack of trading history

and informational opacity. These features pose a difficulty for small businesses to secure loans from financial institutions, such as banks.

- At the second phase of survival during the start-up stage, personal funds become depleted and external sources of funding become necessary. At this stage, the investment in small businesses is still regarded as high risk and the business is not large enough to attract the attention of venture capitalists. Wealthy individuals like business angels can fill the gap between personal funds and institutional venture capital funds. The other appealing factor with regards to business angels is that they contribute their expertise, knowledge and contacts.
- After the small business has passed through the early stages, it requires a further injection of capital to fund growth. At this stage, the SME may still not qualify for debt financing due to its reliance on intangible assets, inability for investors to assess its future growth prospects, low profitability and short track record, thus making the SME unsuitable to raise equity through a public listing. Venture capitalists play a role in alleviating such financing obstacles faced by young firms at this stage. Venture capitalists scrutinize such firms intensively before providing capital and then monitor them closely afterwards.
- In the more advanced stages, such as the emerging and the development stages, the firm has established a track record, has the ability to provide collateral and information regarding its performance and has become more transparent, such that it may access securitized debt and publicly listed equity markets. The debt financing the firm can access include bank loans, mezzanine funding, and debt securities.

9.0 SMES Financing Through Capital Markets

SMES have largely relied on bank loans for financing rather than capital markets. However, since the financial crisis, access to bank lending has become more challenging following a period of bank deleveraging, reduced lending and tighter lending criteria by banks as well as the introduction of more stringent capital requirements associated with Basel III. In this regard, and against the backdrop of a shift towards market-based financing, there is therefore a

greater need for capital markets to play a stronger role as a source of financing for SMES.

The survey responses clarify the following crucial points on the respondents' views about the efficiency of raising equity capital in comparison to other financing options.

- Raising equity capital by means of capital markets primarily offers access to capital via an organized, transparent, orderly functioning and reliable market.
- Unlike borrowing, equity finance does not require principal and interest payment obligations that may put pressure on the cash flows of a company.
- Also, with regard to equity financing and listing on a stock exchange, firms can benefit from the positive effects of market discipline on the quality of management and from greater visibility for potential investors, suppliers and clients.
- SMES generally have limited access to venture capital and debt funding, particularly at the early stages in their life cycle. In order to promote new areas of growth and move towards an innovation-led economy, there is a need to strengthen new avenues of financing to support start-ups and innovative firms. Banks are typically not structured to take on these types of financing, and because of this, access to equity capital is key to financing the growth of these firms.
- Financing options appropriate for an SMES issuer will depend on many factors, including its stage of development, business plan, industry segment, management experience and marketing experience. The majority of SMES are not publicly traded so it would appear capital market financing is either not an attractive and/or viable option for most of them.
- In terms of efficiency, raising equity capital may involve a longer process when compared to other financing options. It may also require a greater initial outlay of costs and involve ongoing regulatory and administrative compliance requirements.
- SMEs choose to raise funds by way of equity financing for reasons that are unique to their particular circumstances, owners and management. Whilst borrowing rates may be higher than the cost of equity capital, the overall

cost of listing and ongoing compliance may outweigh the benefit of that lower cost.

- Therefore, the following issues would have to be considered in conjunction with the other benefits of being a publicly traded company:
- Better access to capital for growth with opportunities to raise funds both at the time of listing and at later stages.
- Higher profile and visibility in the market resulting in increased business, greater assurance among the company's customers and suppliers and an improved corporate image.
- Increased corporate transparency to gain recognition from institutional funds and the investing public.
- Improved corporate governance as a result of listing requirements to help improve management efficiency and information flow.
- Fostering employee motivation and loyalty through stock option programs.
- Raising funds from capital markets after listing by issuing new securities, since investors are often prepared to provide follow-up funding as the business grows.
- Present incentive for greater venture capital participation by providing them an exit route.

9.1. Equity capital markets

Multi-tiered markets have been increasingly important in providing a viable option for SMEs to access market-based financing while addressing the demands of various parties.

For example, by providing SMEs with specific entry and regulatory requirements tailored to their characteristics at lower listing cost compared to the main market as well as acting as a liquidity provider with a wider investor base on a transparent and compliant platform (IOSCO, 2014).

Notwithstanding, there are still certain challenges to the widespread use of multi-tiered markets for SMEs.

For example, although the listing cost is lower compared to the main market, the average cost for companies to list (USD 80- USD 100 000) and remain listed (USD 100- USD 120 000 per annum) can be high for some SMEs which suggests that SME listing platforms are more suited to larger SMEs (Oliver Wyman Report, 2014).

In Korea and Turkey, there are specific market segments for SMEs within the main exchange. The listing and disclosure requirements are relaxed in both countries compared with the main markets. There are also government, exchange or regulator incentives to improve SME listings. Over-the-counter (OTC) markets for unlisted companies, which are mostly SMEs, are also established in both countries. Generally, market advisors assist the companies to list on the exchanges. In Turkey, SME equities are traded with a market making system, whereas in Korea, continuous trading takes place. According to the ADB Working Paper Series on Regional Economic Integration (2014), in emerging Asia, equity financing venues for SMEs have been mostly created under stock exchange operations (ADB Working paper, 2013). India has recently developed dedicated stock exchanges for SMEs, following the recommendation of the Prime Minister's Task Force in June 2010. The Bombay Stock Exchange (BSE) launched the SME Exchange in March 2012 and it had 41 listed SMEs as of 19 November 2013. The National Stock Exchange (NSE) has also launched the SME platform named Emerge, with three listed SMEs (ADB Working Paper, 2013).

KOSDAQ is the largest organized market for SMEs and venture businesses in the Republic of Korea and is operated by the Korea Exchange (KRX). As KOSDAQ is becoming a funding venue for high-end larger enterprises, a new market designed for SMEs named KONEX was launched under KRX in July 2013. MESDAQ under Bursa Malaysia was re-launched as the ACE (Access, Certainty, and Efficiency) market in August 2009, a sponsor-driven alternative market. Catalyst in Singapore is a Singapore Exchange (SGX)-regulated but sponsor-supervised market for rapidly growing enterprises, modeled on the UK-AIM (December 2007). The Securities Exchange of Thailand (SET) has operated the market for alternative investment (mai) since June 1999, targeting SMEs as potential issuers (ADB Working Paper Series, 2013).

In China, the Shenzhen Stock Exchange (SZSE) has developed a three-tier market venue comprising the Main Board, SME Board (May 2004), and the GEB (October 2009; high-tech venture board), in line with national economic development strategies. Hong Kong, China's Growth Enterprise Market (GEM), is an alternative stock market for

high-growth enterprises operated by the Stock Exchange of Hong Kong Ltd. Another successful equity market in China that was established in 2013 is NEEQ, which was designed to address the different needs of SMEs of varying size and stages of development. Market making services were launched on the NEEQ in August 2014.

9.2. Debt capital markets

The Oliver Wyman report titled "Towards Better Capital Markets Solutions for SME Financing" postulated that given the low interest rates seen in most developed markets, issuing debt securities has become a better option than equity IPOs. In Europe there has been an increase in small bond issuances of less than USD 15.6 million. With equity platforms, issuing debt securities is better suited to the more mature and larger SMEs. According to the report, Spain recently set up MARF, an alternate fixed income platform designed to ease access to the market for both issuers and investors, and that NYSE Euronext recently announced plans to promote the issuance of corporate bonds by SMEs via its Alternate Capital Markets Platform.

The report also mentions that several regional stock exchanges in Germany have successfully launched SME debt platforms in recent years. As a result, close to USD 4.2 billion have been raised via the SME bond market platforms established individually by the Düsseldorf, Frankfurt, Hamburg-Hannover, Munich and Stuttgart exchanges. These initiatives are encouraging and are worth exploring further. Issuing equity and debt securities can provide SMEs with a stable, long-term financing that bank lending typically does not.

Because these securities are tradable, their prices provide information about the performance and value of the SMEs concerned. This transparency, combined with the ease of exit created by tradable equity and debt, makes SMEs more attractive investments for venture capitalists (VCs), thus creating discipline on SMEs' management, improving their internal governance and external communications (ADB Working Paper Series on Regional Economic Integration, 2014). It should however, be cautioned that corporate bond markets are generally not as liquid as government bonds, and therefore SME corporate bond issuances would be no exception.

Based on survey responses, the majority of the jurisdictions including Argentina, Australia, Brazil, Colombia, Chinese Taipei, Denmark, Egypt, Greece, Hong Kong, Hungary, India, Italy, Kenya, Lithuania, Maldives, Malawi, Oman, Pakistan, Peru, Poland, Portugal, Slovenia, Spain, and Thailand indicated that their non-equity securities markets have not been sufficiently developed in terms of depth and liquidity.

By contrast, Korea, Malaysia, New Zealand, Germany, Canada, Iceland, Dubai, South Africa, Panama and Singapore believe that non-equity markets are adequately developed for securities issues by SMEs. Jurisdictions were asked to provide information on the outstanding amount and default rates of SME issuers in corporate bond markets.

Additionally, they were surveyed on whether there are any measures and/or criteria to differentiate SME issuers from other senior issuers. Almost all jurisdictions have indicated that they do not have any measures or criteria to differentiate SME issuers from large issuers in the corporate bond markets.

9.3. Crowd funding

Crowd funding is more popular or rather successful in advanced economies, as it is quite dependent on mature internet markets and access to money (disposable income or GDP per capita). Every country has its own regulations and culture with regards to online sales and donations, making it difficult to make blanket predictions on potential international outcomes.

In South Africa, for instance, payments need to be for goods or services rendered. If you want to send money to someone, it is considered a remittance and remittances have to go through an entity with a banking licence

(<http://www.wernervanrooyen.com/crowdfunding-in-south-africa-rewards-based-charitable-and-equity/>).

Crowd fund investing is a valuable tool for individual and institutional investors, as well as for policy makers and for public sector SME funds because of its efficiency, transparency, and market validation

(<http://www.cipe.org/blog/2013/11/20/crowdfundings-potential-for-entrepreneurs-in-emerging-markets/#.VV1KIPmqkko>).

- Efficiency: By consolidating a standard set of applicant data on one platform, crowd fund investing sites speed up the process of

investigating and comparing different project ideas, companies, and management teams. Democratic access to this data speeds up and simplifies decision making.

- Transparency: With open data and social decision making also comes greater transparency. Users of crowd funding websites quickly expose fraudulent campaigns and vigorously hold fundraisers to account for their promises. According to Wharton Professor Ethan Mollick, less than 0.1 percent of the funds raised on crowd funding websites are raised by people with no intention of delivering on the promises they make.
- Market validation: When a particular idea proves a hit with individual investors, it can also enhance its attractiveness for institutional investors to act as lead investors or co-investors. In similar fashion, crowd funding can be a neat selection mechanism for public sector SME funds — some of which have more funds for entrepreneurship than they do the ability to disburse them

(<http://www.cipe.org/blog/2013/11/20/crowdfundings-potential-for-entrepreneurs-in-emerging-markets/#.VV1KIPmqkko>).

Crowd funding still has plenty of obstacles to overcome in emerging markets. One major challenge is trust. In a recent Tech Crunch article, Seed Asia co-founder Tom Russell noted that transparency which has become the hallmark of successful Western crowd funding projects often presents challenges for many Chinese entrepreneurs, primarily due to the fear that their work or ideas may be infringed upon by competitors

(<http://www.forbes.com/sites/hsbc/2014/08/05/crowdfundings-untapped-potential-in-emerging-markets/>).

However, although such concerns may exist, crowd funding has experienced rapid development in China. About 30 equity crowd funding platforms had been set up, with over RMB 1 billion raised for more than 30,000 projects by the end of 2014.

Brazil's crowd funding ecosystem is also facing some tough hurdles. There is what is known as the “custo Brasil” or the Brazil Cost, an umbrella term for the legal and bureaucratic frustrations international businesses often face when doing business in Brazil. Inexperienced entrepreneurs who

use crowd funding may not be able to follow through with their projects if the custo Brasil is too high. Brazil also lacks a firm legal framework for crowd funding, and currently operates under e-commerce laws (fundings-untapped-potential-in-emerging-markets/). In view of this scenario, the Brazilian regulator, based on a study of the international experience, is working on the guidelines of a regulatory framework addressing the matter.

Chinese Taipei has completed issuance of related regulations on crowd funding at the end of April, 2015. The Financial Supervisory Commission (FSC) will allow securities brokers meeting specific criteria to operate equity crowd-funding. As for rules regarding fund raising companies and investors, the company can only raise up to USD 486,493 annually, and the investors can only invest USD 1,622 at most in one fund-raising project and total annual investment via one platform shall not exceed USD 3,243

(<http://www.fsc.gov.tw/en/home.jsp?id=55&parentpath=0,4>). Chinese Taipei has also introduced a Go Incubation Board for Startup and Acceleration Firms (GISA). GISA is designed as the platform for small-sized non-public innovative companies with creative ideas, and to offer entrepreneurship counseling and capital raising functions, but not trading functions to help innovative companies to acquire needed capital.

There is a limitation on the amount of capital raising through GIS, whereby the company (including a GISA registered company) or a preparatory office can only raise up to USD 486,493 to add to its capital annually through GISA (not including employees' and original shareholders' purchasing prior to GISA registering). There are potential benefits for new businesses. However, governments and the private sector are required to make a concerted effort to ensure that crowd funding is successful.

- First, they should define clear regulatory frameworks and robust market regulations to yield investor confidence in local financial markets.
- Second, direct foreign investments, supported by the right policy framework, can support technology and infrastructure environments, i.e. the crowd funding platforms.
- Third, they should support entrepreneurship stakeholders at the grassroots level by offering, for example, training for entrepreneurs, business

accelerators, incubators, mentor networks and other service providers.

9.4. Sukuk funds

The global Sukuk industry is the fastest growing segment in the Islamic finance industry, and its geographical reach has extended globally with a growing investor base. In 2014, a total of USD 118.8 billion worth of Sukuk were issued, slightly below the USD 119.7 billion in 2013. The global Sukuk outstanding volume surpassed USD 300.9 billion at the end of 2014, a 12.0 percent increase from USD 269.4 billion outstanding at the end of 2013 (http://www.gifr.net/gifr2013/ch_05.pdf).

Innovative developments in the corporate Sukuk markets can complement the corporate debt SME market. It is timely for SMEs to leverage on Sukuk considering that Sukuk have a larger investor base.

A new market such as France has demonstrated that it could come up with a pint-sized Sukuk through an asset-backed hybrid Sukuk using a mudaraba contract worth USD 700,000 in 2012. Sukuk have predominantly been issued by governments and corporates, as well as financial institutions. Sukuk for SMEs to date remains significantly under-developed, although the legal and regulatory frameworks in some jurisdictions support their Shariah compliant financing, including for SMEs.

As in the corporate debt market, the Sukuk market faces the challenge of a non-supportive market structure that does little to help SME sukuk to thrive. Sukuk for SMEs are likely to be more successful when a country does not have a strong banking base nor a dominant corporate market for Sukuk. In this case, SME Sukuk could be the starting point for capital-raising. In other more-developed jurisdictions, changes to the current market structure could pave the way for SME participation in the Sukuk market.

In some countries, governments have established dedicated SME banks to enable SMEs better access to capital. One SME bank has issued a Sukuk to fund SMEs - SME Development Bank Malaysia in 2012 issued a 20-years RM3 billion (USD 1 billion) guaranteed Sukuk. There are also commercial banks that focus on SME financing. Turkey recently witnessed the issuance of 5 year

Sukuk amounting to USD 250 million by its domestic bank which is mainly targeted to finance clients that are primarily SMEs and corporate. Thus Sukuk benefits SMEs indirectly as the financial provider taps into the Sukuk market. Sukuk as an alternative to corporate debt or loans can certainly be looked into as an option for SMEs where banking or the absence of banking inhibits the growth of the industry.

9.5. Securitization

SMES securitization is another avenue that can help bridge the SME financing gap. It also facilitates the transfer of some risks to non-bank financial institutions. Following the global financial crisis, there has been some stigma attached to securitization and reluctance on the part of investors to participate in this segment of the market. In general, securitization markets in emerging markets tend to be relatively underdeveloped compared to developed markets.

However, it is worth considering the potential benefits that securitization offers as well as the need for well-developed, simple and transparent structures to facilitate the use of securitization for SME financing. Among the members surveyed, all except Spain, Italy, Thailand, Portugal, South Africa, Ecuador and Canada, responded that there are no other types of securities issued by SMEs other than equity and corporate bonds such as securitized instruments, pooled bonds or other securities, hybrid instruments, mezzanine finance and covered bonds.

Ontario-Canada responded that generally a majority of securities issuances are equity securities but venture issuers for example have the flexibility to choose to raise capital through issuing other types of securities, either through formal public offering or private placement. Information relating to the outstanding amount and breakdown of securities other than equity and corporate bonds is not readily available at this time.

Italy mentioned that warrants have been issued by SMEs. Thailand and South Africa stated that the outstanding amount of warrants is USD 150 921.58 million and USD 2.4 million, respectively. Ecuador indicated that the total outstanding amount of debentures and commercial papers is USD 6.8 million. Singapore mentioned that USD 93 million of convertible preference shares has been issued in the last five years. Alberta-Canada responded that

Canada venture issuers traded on the venture markets tend to predominantly issue equity securities but they may occasionally issue warrants or debentures that typically are convertible to equity.

Spain has USD 13 531.70 million in outstanding amounts of securitization transactions with underlying assets that are bank loans backed by its government under the condition that financial entities assigning their assets re-invest at least 80 percent of the proceeds received in new credits for SMEs.

They also have USD 2 253.83 million of securitized bank loans to SMEs but the bulk of these funds are backed by private financial institutions, mainly banks and the residual part of these funds are backed by some autonomous regions. Structured products backed by SME loans or assets are not common in Bulgaria, Mexico and Turkey. On the other hand, securitization of SME loans has grown rapidly after the year 2000 in Korea, supported by the credit guarantees of government.

10.0 Capital Market Financing for SMEs: A Growing Need in Emerging Asia

Small and medium-sized enterprises (SMEs) are a backbone of the resilient national economy in every country due to their nature of stimulating domestic demand through job creation, innovation, and competition.

Meanwhile, SMEs involved in the global supply chain have the potential to encourage international trade and to mobilize domestic demand. Prioritizing SME development is therefore critical for promoting inclusive economic growth in Asia.

Given the global economic uncertainty, adequate and stable access to finance is crucial for SMEs to survive and grow.

In Asia, however, most SMEs have been suffering poor access to finance, which is one of the core factors impeding SME development. There is a perceived supply-demand gap in SME finance.

The International Finance Corporation (IFC) and McKinsey & Company estimated the value of the gap in formal SME credit in 2010 at US\$700 billion–US\$850 billion, which is equivalent to 21%–26% of the total formal SME credit outstanding in the developing world. If informal SMEs and microenterprises are included, the total gap in deve-

loping countries in terms of unmet financing demand exceeds US\$2 trillion. Such a supply-demand gap suggests the limitations of bank lending for enterprises in raising sustainable and safe funds for business, especially for SMEs.

On the whole, SMEs, especially start-ups, tend to have a lower probability of survival than larger firms, which creates a general pattern of simultaneous high rates of SME market entry and exit across virtually all economic sectors and encourages financial institutions to regard them as being inherently riskier loan prospects than larger firms. Hence, banks' hesitation to provide long-term financing owing to uncertain economic circumstances is seriously affecting SMEs' growth capital funding. Bank-centered financial systems in Asia require robust capital markets as an alternative channel for providing growth capital. The development of long-term financing instruments for high-end SMEs and proper regulatory frameworks for new instruments will be a key growth agenda among policy makers and regulators, which should be incorporated into a comprehensive menu of policy options on SME finance. SME capital markets should be well designed to mitigate risks arising from the external environment, which requires a sophisticated institutional mechanism supporting SMEs in direct finance as well as managing any possible risks.

10.1. SMEs equity markets

In emerging Asia, equity financing venues for SMEs have been mostly created under stock exchange operations. In the People's Republic of China (PRC), the Shenzhen Stock Exchange (SZSE) has developed a three-tier market venue comprising the Main Board, SME Board (May 2004), and ChiNext (October 2009; high-tech venture board), in line with national economic development strategies. Hong Kong, China's Growth Enterprise Market (GEM) is an alternative stock market for high-growth enterprises, operated by the Stock Exchange of Hong Kong Ltd. India has recently developed dedicated stock exchanges for SMEs, following the recommendation of the Prime Minister's Task Force in June 2010. The Bombay Stock Exchange (BSE) launched the SME Exchange in March 2012 and it has 41 listed SMEs as of 19 November 2013. The National Stock Exchange (NSE) has also launched the SME platform named Emerge, with 3 listed SMEs. KOSDAQ is the largest organized market for

SMEs and venture businesses in the Republic of Korea and is operated by the Korea Exchange (KRX). As KOSDAQ is becoming a funding venue for high-end larger enterprises, a new market designed for SMEs named KONEX was launched under KRX in July 2013. MESDAQ under Bursa Malaysia was re-launched as the ACE (Access, Certainty, and Efficiency) market in August 2009, a sponsor-driven alternative market. Catalist in Singapore is a Singapore Exchange (SGX)-regulated but sponsor-supervised market for rapidly growing enterprises, modeled on the UK-AIM (December 2007). The Securities Exchange of Thailand (SET) has operated the market for alternative investment (mai) since June 1999, targeting SMEs as potential issuers.

Equity markets for SMEs in emerging Asia are typically small in scale, with market capitalization equal to less than 10% of GDP and market performances that significantly vary by country. In the PRC, both SME Board and ChiNext have been sharply expanding in terms of size and the number of listed companies, with more than 1,000 listed companies in both markets combined, although their growth rates have slowed recently. KOSDAQ and Hong Kong, China's GEM enjoyed V-shape recoveries from the GFC, but the growth of these markets tends to be slowing with little new listings. The market size of Catalist Singapore, ACE Malaysia, and mai Thailand has not expanded well like similar markets in the PRC and the Republic of Korea, and their listed companies are not increasing at a sufficient pace. This suggests that equity markets in Asia, except for those in the PRC and the Republic of Korea, have not yet become a financing venue for SMEs. Extensive national policies and strategies for improved SME access to capital markets are needed.

10.2. SMEs bond markets

There is a new movement for creating an SME bond market in countries such as the PRC and the Republic of Korea. In the latter, a qualified institutional buyer (QIB) system was established for SME bond trading in May 2012. However, SME bond transactions under the QIB system are quite limited and not attractive to individual and institutional investors due to the existence of low investment grade bonds (BB or below). The PRC has developed three types of SME bond instruments: (i) SME Collective Note, (ii) SME Joint Bond, and (iii) SME Private Placement Bond. The SME Collective

Note market is an inter-bank market regulated by the People's Bank of China (PBOC) and the National Association of Financial Market Institutional Investors (NAFMII). It is growing rapidly, with annual issuance of CNY10.6 billion in 2012. An SME Collective Note is issued on behalf of between two and 10 SMEs and generally guaranteed by a government guarantee institution. SME Joint Bonds are traded in the inter-bank and exchange markets, which are regulated by the National Development and Reform Commission (NDRC), but the issuance volume is quite limited at CNY0.98 billion in 2012. SME Private Placement Bonds are regulated by the China Securities Regulatory Commission (CSRC). The plural regulators are involved in the SME bond markets in the PRC.

10.3. Potential for developing SME capital markets

Provided that increasing bankability is a traditional policy priority in SME finance, policy makers in Asia had not considered the development of SME capital markets significant for a long time due to the following reasons: (i) bank-centered financial system established, (ii) capital markets yet underdeveloped, (iii) fragile internal control systems of SMEs, (iv) no demands on SMEs and investors for capital market financing, and (v) cost and size matters for establishing and operating SME capital markets. However, such preconceptions are not proved with clear evidence, and advanced technology may make possible the creation of SME capital markets with reasonable costs. Besides, less coordination among multiple policy makers responsible for SME sector development and finance may have hindered the policy formulation of capital market financing for SMEs. This section assesses the real intention of supply-side (regulators, policy makers, market organizers, securities firms, and investors) and demand-side (SMEs) for developing an SME market, based on the findings from intensive surveys, and explores possible directions on increasing long-term financing opportunities for SMEs.

10.4. The startup tax and the related issues for the investors

An innocuous clause in Budget 2012 is a potential time bomb for startups looking for funding. An investment in any private company could be classified as "income" unless they can justify the

valuation to a tax officer. If they fail to do that, the startup will pay tax on the investment. We'll explore what this new clause is, and how it impacts startups. And then, what you can do to protest, and known work-around.

A startup gets funding from a seed or angel investor in exchange for equity. The valuation at the time is usually based on an idea, with very little else to support it. A startup can be two people working out of a garage, or nowadays, out of home or coffee shops; no assets, very little money. Long on potential, short on navy blue suits. When a company is created, shares are issued to the initial investors at "par" or at face value, in proportion to their investment. For example, take a company started with 100,000 rupees (one lakh rupees), with two founders putting in Rs. 60,000 and Rs. 40,000. Each will get 6,000 and 4,000 will get shares of Rs. 10 face value, respectively, for a total of 10,000 shares.

The founders work for 6 months and build a prototype for software to revolutionize online payments. They demonstrate this, with a business plan, to an angel investor, showing how similar companies have made enormous sums of money. They then ask for Rs. 20 lakh as an investment to hire people, buy some equipment and for marketing. At this point, the software company has nothing but a prototype. It might have talked to customers, identified people to hire, earmarked funds for purchases if they got the money. It has spent nearly 75,000 of the one lakh rupees the founders put in, on paying rent on a small office, travelling to meet prospective customers, and designing their web site. Startups hardly have any assets worth speaking about. Most of the valuation is the potential of the idea, and the confidence in the founding team. These aren't classified as assets in the tax parlance.

Bank lending is the most common source of external finance for many SMEs and entrepreneurs, which are often heavily reliant on straight debt to fulfill 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.

The WPSMEE has long recognised the limitations of traditional debt financing for responding to the different financing needs that SMEs encounter along their life cycle, and for sustaining the most dynamic enterprises.

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. Yet, for most enterprises, there are few alternatives to traditional debt. 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 crises, 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. 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.

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, 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.

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.

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