The European SME Financing Gap:
The Credit Conundrum

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1. Overview and motivation

- Small- and medium-sized enterprises (SMEs) account for the majority of business activity in most countries and play a vital role in stimulating growth, innovation and competitiveness. It is therefore important to assess the degree to which SMEs are provided with adequate access to lines of credit and financing options to enable their growth and stability.

- According to the Bank of England[1], the stock of lending to SMEs has been contracting since late 2009, with latest figures showing negative growth once again in the three months to May 2012.

- This report aims to provide an up-to-date estimate of the shortfall in available financing experienced by small-to-medium enterprises (SMEs) in Europe. This so called `financing gap' is the difference between SMEs' required credit and that which is being utilized in practice, whether due to lack of supply or equally due to lack of demand.

- We estimate a total European SME financing gap of between £116bn and £200bn ($188bn to $324bn) a year. More detailed cross-country comparisons are made difficult by the disparate definitions of SMEs in different countries.

- In the UK alone, we estimate that between c.200,000 and 350,000 SMEs might be affected by failure to close this gap, with between 370,000 and 670,000 jobs potentially being saved and/or created if the gap were to be closed.

- Some insights into strategies for bridging this gap are also discussed. These include government policies, as well as less conventional financing options such as asset-based financing and peer-to-peer lending.

2. SME financing gap in the UK

- Estimates of the SME financing gap in the UK are obtained from a 2012 report by the UK Department of Business Innovation and Skills (BIS)[2]. The BIS calculations are based on the observed correlation between nominal GDP growth and the volume of outstanding SME debt. Their gap estimate is obtained by comparing the projected outstanding debt over the next five years with the `required' level of debt, i.e the debt corresponding to the level of GDP growth forecast by the Office for Budget Responsibility (OBR).

- In the BIS report, the UK SME financing gap over the next five years (Q4-2011→Q4-2016) is estimated to be between £26bn and £59.3bn. This estimate is made only for medium-sized enterprises, defined as those with a turnover between £1m and £25m.

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[1] Bank of England - Trends in Lending (July 2012)

[2] BIS; *Boosting Finance Options for Business*; (London, March 2012)

- The higher gap estimate is obtained by assuming that debt incurred during the recent period of financial distress is tied up and will not contribute to economic growth and hence additional credit will need to be made available in order to drive recovery. The average of these two estimates is £42.65bn.

- We obtain low- and high- estimates of the *annual* UK `medium-sized-company' gap by (a) dividing the five-year average by the number of years and (b) by assuming a gradual recovery[3] over the five-year period, respectively. This yields an estimate of between £8.53bn and £15.51bn for the annual UK medium-company financing gap.

- Our estimate of the total *European* SME financing gap will rely on the ratio between our estimate of the total UK gap and the total amount of outstanding SME lending in the UK. We will make the assumption that this ratio is similar in other European countries in order to obtain estimates of their financing gaps. Figures for total SME lending in European countries is obtained from a recent (2012) OECD report[4]. We note that up-to-date European SME financing data is difficult to obtain, and even this most recent report relies on 2010 figures, both for the UK and for other European countries. Fortunately, a recent British Banking Association (BBA) report[5] provides updated figures of UK SME lending which we will use in place of the OECD data for the UK in order to allow a fair comparison with the gap estimates.

- Prior to this comparison with other European countries, however, we wish to include small companies (i.e. those with turnover *below* £1m) in our estimate of the UK financing gap. In order to do so we rely on the current figures for total UK SME lending taken from the BBA report mentioned above. As of March 2012, total SME lending to businesses in the income range up to £1m was £39.2bn (a 24% decrease from the £51.96bn of 2010), while lending to companies with turnover between £1m-£25m stood at £64.5bn.

- To estimate the small-company gap, we scale our medium-sized-company gap estimate down by the ratio between these two figures. Hence we are making the naive assumption that the ratio between total outstanding debt and gap size is similar for small- and medium-sized businesses. The resulting scaling factor is 1.65 (i.e. 64.5/39.2), which gives low and high estimates for the annual small-business financing gap of £5.17bn and £9.4bn, respectively.

- Combining each of these with their respective medium-size-company gap estimates from above gives final low and high gap estimates for the annual UK SME financing gap of **£13.7bn** and **£24.9bn**, respectively.

- Expressed as a percentage[6], this means that UK SMEs are falling short of the total credit they need by 12% and 19%, in the low- and high-gap scenarios, respectively.

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[3] We assume a declining rate of change, meaning that in 2012 much of the gap will remain (namely, $\frac{4}{11}+\frac{3}{11}+\frac{2}{11}+\frac{1}{11}+\frac{1}{11}$ for the five years, i.e. $\frac{4}{11}\cdot 42.65=15.51$).

[4] OECD; *Financing SMEs and Entrepreneurs: An OECD Scoreboard 2012*; (April 2012)

[5] BBA Statistics - *Banks' support for SMEs* (August 2012)

[6] i.e. $z=\frac{x}{x+y}$ with y the total amount lent to SMEs and x the UK SME financing gap.

- It is worth pointing out here that SMEs currently make up 99.9% of all active UK businesses by number, account for 58.8% of all private-sector employment and generate 48.8% of all turnover in the UK. Table 1 below summarizes these figures and provides a breakdown according to company size. This highlights the importance of accounting for both small and medium enterprises in our financing gap estimates, as both these categories contribute greatly to overall employment and revenue.

	Enterprises	Employment (1000's)	Turnover (£m)
All enterprises	4,542,765 **(100%)**	23,391 **(100%)**	3,052,558 **(100%)**
SMEs (0-249 employees)	4,536,445 **(99.9%)**	13,760 **(58.8%)**	1,489,255 **(48.8%)**
With no employees	3,364,020 **(74%)**	3,684 **(15.7%)**	202,431 **(6.6%)**
1 - 9 employees	968,545 **(21%)**	3,651 **(15.6%)**	202,871 **(6.6%)**
10 - 49 employees	173,405 **(4%)**	3,469 **(14.8%)**	460,500 **(15%)**
50-249 employees	30,475 **(<1%)**	2,957 **(12.6%)**	422,454 **(13.8%)**
>250 employees	6,320 **(0.1%)**	9,631 **(41.2%)**	1,563,302 **(51.2%)**

Table 1 - Summary of UK SME statistics, at the start of 2011. Source: *BIS - Business population estimates for the UK and regions (2011)*. Entries for small companies are highlighted in blue and those for medium-sized companies are highlighted in red.

- In order to put these gap estimates into perspective and get a sense of the number of potentially affected businesses, we make use of lending figures from the recent BBA report[7], which estimate the average borrowing sum of small businesses in Q1 2012 at £36k, and that of medium businesses at £166k. This implies that the estimated financing gap from above would lead to between c.200,000 and 350,000 potentially affected businesses, in the low- and high-gap scenarios, respectively.

- It is difficult to accurately estimate the number of jobs that might be preserved or newly-created as a result of closing the financing gap. In evaluating the government's 2009 Enterprise Loan Guarantee (ELG) scheme, for example, a BIS report[8] concluded that the average loan size per SME (c.£100k) saved/created an average of 2.7 jobs per firm. Using this figure together with the average loan amounts and estimated financing gaps for small and medium businesses separately, we arrive at a range of between 370,000 and 670,000 jobs in total which could potentially be saved and/or created as a result of closing the financing gap[9].

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[7] BBA Statistics - *Banks' support for SMEs* (August 2012) - see source data (available online)

[8] BIS - Early Stage Assessment of the Impact of the Enterprise Finance Guarantee (EFG) on Recipient Firms (2009)

[9] We assume here an average of 2.7*(36/100) = 0.97 jobs saved/created per small business, and 2.7*(166/100) = 4.48 jobs saved/created per medium-sized business. We then find the number of small and medium businesses affected by dividing their respective gap estimates by their average loan size, and obtain the corresponding number of employees by simply multiplying the jobs-affected number by the number of companies and summing.

- We note that since the financing gap refers to the required growth in *outstanding* SME debt, actual loans made will have to be larger than this gap in order to account for repayments. Repayments will act to reduce the outstanding SME debt and hence the above estimate of the number of affected companies/jobs might be viewed as an underestimate.

3. SME financing gap in Europe - an estimate

Data availability

- There is a consensus in the European Commission (EC) and the OECD about the importance of SMEs' role in any economy recovery plan. Despite this, "there are no reliable data across countries on the volume of SME financing."[10]

- This is due to the lack of an internationally accepted definition of what constitutes an SME, reluctance from firms "to share information on the dollar amounts of their operations during interviews"[11], and the consequent dependency on credit providers - a fragmented market in many countries - for information.

- The most widespread definition of an SME is the EU one, requiring (i) fewer than 250 employees, (i) annual turnover below €50m and/or (iii) a balance sheet below €43m. Denmark, Switzerland and the UK, by contrast, require only fewer than 250 employees. Worse still, banks in different EU countries each use their own SME definitions for reporting lending figures. These disparate criteria are included for comparison in Table 2.

- Data, where available, can be several years old. As mentioned above, the most recent OECD report (2012) quotes total SME lending figures from 2010.

Financing gap estimation

- Data for total SME lending in twelve European countries (including the UK data mentioned above) is obtained from the OECD report. Germany, Austria and Spain's financing gaps are not provided, as these countries' figures for SME lending are not included in the OECD report and are not available.

- The main assumption behind our estimate is that the *fractional* financing gap for the other European countries is similar to that in the UK (i.e. 88% and 81% in the low- and high-gap scenarios, respectively).

- These ratios have been used, together with the total SME lending figure for each European country listed in the OECD report, to estimate their absolute financing gaps. Table 2 below summarizes total SME lending figures and our financing gap estimates[12].

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[10] CGAP; *Financial Access 2010: The State of Financial Inclusion throughout the Crisis*; (Washington, D.C., Sept 2010); p. 35
[11] ibid
[12] *Currencies (DKK, EUR, HUF, SEK, CHF) converted to GBP using 7/9/2012 exchange rates.*

Country	SME Lending (£bn) *	Annual Gap - low (£bn) †	Annual Gap - high (£bn) †	Criteria for SME lending value*
Denmark	3.72	0.51	0.87	Loan size < €1m
Finland	6.16	0.84	1.44	Loan size < €1m
France	180.16	24.57	42.26	EU definition
Hungary	11.38	1.55	2.67	EU definition (with assets < €10m)
Italy	163.09	22.24	38.26	Firm size < 20 employees
Netherlands	13.09	1.78	3.07	Loan size < €1m
Portugal	73.30	10.00	17.19	EU definition
Slovak Republic	9.54	1.30	2.24	Firm size < 250 employees
Slovenia	8.32	1.13	1.95	Firm size < 250 employees and assets < €17.5m
Sweden	73.04	9.96	17.13	Firm size < 250 employees
Switzerland	211.65	28.86	49.65	Firm size < 250 employees
United Kingdom	103.7**	13.70	24.90	£1m < Turnover < £25m (see text)
Total	**857.15**	**116.44**	**201.64**	---

Table 2-Summary of total SME lending and low- and high estimates of the financing gap in European countries.
* Reported in *Financing SMEs and Entrepreneurs: An OECD Scoreboard 2012*
** Obtained from BBA Statistics - *Banks' support for SMEs* (August 2012)
† Estimated (see text)

- This places our estimate for the annual European SME financing gap at between £116bn and £200bn ($188bn to $324bn) for the low- and high scenarios, respectively.

4. Notes on results

- Inasmuch as their underlying assumptions are valid, the total gap estimates given here represent an underestimate since many European countries have not been included in the overall tally (for example, Germany, Spain, Austria, Poland, Belgium, Greece, Ireland, and others). Furthermore, most of the entries in Table 2 also represent an underestimate of the magnitude of the gap since the reporting criteria listed in the rightmost column are generally subsets of the EU definition of an SME - i.e. actual lending to companies meeting the EU SME criteria will be higher than the figures given.

- We have made the assumption that the financing `supply-to-demand' ratios of other European countries are similar to those in the UK. This is partially justified by the similarity in the loans authorized/requested percentage between the UK and the European Union. In the UK, 74% of SMEs received all or part of loans requested in 2010[13]. In the Euro area, this figure was 75% in the second half of 2009[14]. This suggests access to bank lending for SMEs is similar between the two areas.

[13] OECD; *Financing SMEs and Entrepreneurs: An OECD Scoreboard 2012*; (April 2012); p. 161
[14] European Central Bank; *Survey on the Access to Finance of Small and Medium-sized Enterprises in the Euro Area: Second Half of 2009*; (Frankfurt, 2010); p. 2

- Although this assumption allows us to estimate the total size of the European SME financing gap, it makes it difficult to carry out any useful comparisons of financing gaps across countries (since all countries are assumed to have the same fractional gap). This will likely continue to be the case until more 'harmonized' definitions and reporting standards are established across different countries.

- Finally, it is important to bear in mind that the gap estimates provided for the UK[15] are extracted from forecast models relying on assumptions which, despite being supported by qualitative evidence obtained during interviews with companies and other stakeholders, should nevertheless be treated with the usual degree of caution.

5. Addressing the problem

- Although growth in bank lending may meet some of this estimated financing need, recent tightening of regulations limiting banks' ability to take on risk might have a disproportionate impact on smaller businesses, which are often riskier and hence have higher risk weightings attached to their investments[16].

- It is therefore worth examining other strategies which might be employed to address any financing shortfall. We divide these into government measures and non-bank lending, as discussed in the sections below.

Government measures

- The UK government has recently announced the launch of the Funding for Lending Scheme (FLS), an £80bn funding initiative "designed to incentivize banks and building societies to boost their lending to UK households and non-financial companies"[17]. Another £1bn will also be made available through the Business Finance Partnership (BFP)[18], which will invest in UK SMEs through non-bank channels.

- John Walker, chairman of the Federation of Small Businesses: "The scheme is designed to help to make finance more affordable as well as easier to obtain. So it is vital the banks which take advantage of the scheme pass on these benefits to the small businesses it is intended for. Over the last quarter, four in 10 small firms were refused credit."

- Another noteworthy example of government-backed support is seen in Germany. KfW is a state-run bank which runs a large division (the *Mittelstandsbank*) focused solely on providing loans with preferential interest rates to Germany's SMEs. The bank currently manages over €5.8bn (£4.6bn) directed specifically at start-ups and general corporate

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[15] BIS; *Boosting Finance Options for Business*; (London, March 2012)
[16] http://www.bis.org/bcbs/basel3.htm
[17] http://www.bankofengland.co.uk/markets/Pages/FLS/default.aspx
[18] http://www.bis.gov.uk/business-finance-partnership

finance[19]. A relatively large number of cooperative banks also serves to broaden credit availability for SMEs. As a result, in Germany: "Surveys of credit availability for companies show conditions are as benign as in 2008 before the financial crisis swelled. One survey of financing constraints for construction companies found better conditions than at any time in the past two decades."[20].

- The UK government has very recently announced its intention to establish a state-backed `business bank' to boost lending to UK companies[21], although the "scale, scope and timing" of the project have yet to be finalized[22].

- It is clear that there are many ways in which governments can encourage, incentivize and enforce greater access to financing for SMEs. These fall into several categories, as described in the BIS report[23], some of whose recommendations are outlined below:

1. Increasing awareness for alternative forms of finance

- For example, by introducing a Business Finance Advice scheme and through effective promotion of Government Access to Finance programmes[24]

2. Improving SMEs access to capital markets financing

- For example, by the creation of a government-backed SME bond market. In Germany, for example, the SME bond market is growing rapidly. Over €2bn (£1.6bn) has been raised through these issues[25]. NESTA, in 2011, examined the possibility of bringing this idea to the UK. They concluded that this could help address the UK's "dependence on a relatively small number of banks and the relatively small size of non-bank lending options."[26]

- By increasing the number of Private Placement investors, providing an alternative to public share offerings.

- By increasing investor appetite for bonds by, for example, introducing additional tax incentives for investing in SMEs.

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[19] KfW Bankengruppe; *Semi-Annual Report 2011*; http://www.kfw.de/kfw/en/I/II/Download_Center/Financial_Publications/Financial_publications/4_Halbjahresberichte_E/KfW_HalbjahresBericht_2011_EN_barrierefrei.pdf; p. 2

[20] Financial Times; *Germans enjoy credit glut;* 20 February 2012; http://www.ft.com/cms/s/0/39f6d720-5bc1-11e1-a447-00144feabdc0.html#axzz21NEw066X

[21] http://www.bbc.co.uk/news/business-19554471

[22] http://www.telegraph.co.uk/finance/newsbysector/industry/9536366/Vince-Cable-tells-sceptical-firms-that-the-Business-Bank-will-happen.html

[23] BIS; *Boosting Finance Options for Business*; (London, March 2012)

[24] http://www.bis.gov.uk/policies/enterprise-and-business-support/access-to-finance

[25] The Economist; *Financing Germany's Mittelstand: A crisis-born fledgling*; 3 November, 2011; http://www.economist.com/node/21535175

[26] NESTA; *Beyond the Banks: The case for a British Industry and Enterprise Bond*; November 2011; http://www.nesta.org.uk/library/documents/BeyondtheBanksResearchSummaryNov11V2.pdf

3. **Stimulating growth through supporting smaller companies**

- For example, by requiring large companies to pass on any governments payments promptly to their small suppliers and by encouraging faster payments by large companies in general, including tighter enforcement of legislation on late payment.

- Working to accelerate adoption of Supply Chain Finance.

4. **Modifying the regulatory environment**

- Bringing about greater data-sharing by the BBA with non-bank providers.

- Removing barriers on bank lending to support SME trade finance.

5. **Developing new financial products**

- Support of Online Receivables Exchanges and other asset-based finance (ABF).

- Support of peer-to-peer lending platforms.

Non-bank lending

- Non-bank lending provides SMEs with an increasing number of alternative avenues through which to secure the financing they require. This greater choice promotes competition amongst finance providers and leads to greater flexibility and resilience in the financial system.

- We have divided discussion of these new methods of lending into three categories: (i) P2P lending, (ii) equity financing and (iii) online receivables exchanges. An examination of these in the UK was included in the BIS report[27] and we have looked to extend this study to Europe.

Peer-to-peer (P2P) Lending

- The UK government has recently announced a first investment of £100m, as part of the BFP scheme mentioned above, aimed directly at the development of "non-traditional" financing channels such as P2P lending[28].

- Since its launch in August 2010, the UK-based Funding Circle has mediated over £48m of business loans[29]. They project a figure of approximately £200m in the next year, and estimate that they will be able to reach £1bn of lending in the next 3-5 years[30].

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[27] BIS; *Boosting Finance Options for Business*; (London, March 2012)
[28] http://www.bis.gov.uk/business-finance-partnership
[29] https://www.fundingcircle.com/lend/stats/ (Sept. 2012)
[30] BIS; *Boosting Finance Options for Business*; (London, March 2012)

- P2P lending has failed to gain the traction in Europe that it has in the UK. It is possible that this is due in part to the relative lack of credit card debt in other European countries (P2P is frequently used for debt restructuring).

- As Table 3 below shows, the German market trails the volume of lending provided in the UK which, in turn, trails the US, where P2P lending originated[31].

Company	Country	New loans/month ($m)
Auxmoney	Germany	1.96
Smava	Germany	1.73
Isepankur	Estonia	0.05
MYC4	Denmark	0.29
Comunitae	Spain	0.03
Ratesetter	UK	2.59
ThinCats	UK	n/a
Yes-Secure	UK	0.01
Funding Circle	UK	4.66
Zopa	UK	11*
Lending Club	US	29.47
Prosper	US	10

Table 3 - Summary of leading European P2P lending platforms.
* Estimate

- In Germany, money is currently being lent at a rate of approximately $45m (£28m) a year, predominantly across two sites, Smava and Auxmoney[32]. The division in this amount between businesses and personal uses is not known. However, despite Germany being the market leader in mainland Europe, "only approved banks are allowed to issue loans commercially"[33] which means P2P lenders are "struggling to achieve growth."[34]

Equity Finance

- Equity finance is relatively scarce amongst SMEs - it was used by less than one in ten SMEs (7%) in the last half of 2011 in Europe. What's more, only 12% of the SMEs which experienced double digit growth year on year received investment from angel investors and venture capitalists[35]. In the UK, only around 1-2% of SMEs looking for external finance sought equity finance[36].

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[31] Data obtained from P2P-Banking.com. (March 2012)
[32] http://www.wiseclerk.com/group-news/countries/germany-updated-state-of-selected-p2p-lending-companies/
[33] Luther Law; *Luther Newsletter*; February 2012; http://www.luther-lawfirm.com/download_newsletter_de/373.pdf
[34] http://www.wiseclerk.com/group-news/countries/germany-updated-state-of-selected-p2p-lending-companies/
[35] Ipsos Mori; 2011 SMEs' Access to Finance Survey; December 2011;
http://ec.europa.eu/enterprise/policies/finance/files/2011_safe_analytical_report_en.pdf; p. 20
[36] BIS - SME access to External Finance (January 2012)

- Two possible ways to help change this are crowdfunding and growth markets:

  - Crowdfunding websites offer small businesses the opportunity to reach amateur investors on the internet. Crowdfunding websites are mainly reward-based funders: companies give rewards (like merchandise) to investors, as opposed to equity. Giving crowdfunding investors equity is a new concept and is yet to grow outside the UK.

  - Growth markets are essential to providing an exit strategy for investors. The micro and small cap market is considerably fragmented in Europe, with each stock exchange catering mostly to companies in the country in which they're located. This inhibits access to European capital. The European Commission has pursued a 'harmonization' of regulation, in order to enable a pan-European stock exchange, since at least 2005[37]. This goal was echoed again in February 2012[38].

Online Receivables Exchanges

- There is nothing new about factoring (selling uncollected invoices at a discount). However, the emergence of online receivables exchanges in the UK, which pair buyers and sellers, stands to make the process considerably more fluid for SMEs.

- No such online exchange exists in mainland Europe despite a €1.11bn (£0.89bn) market in accounts-receivables (AR) finance[39]. Penetration amongst small businesses remains small however: 4.1% of all UK SMEs used AR finance in 2010, 3.1% in France, slightly less than 2% in Italy and 1% in Germany[40].

- GE Capital estimate that AR financing could add £7bn to the UK's quarterly GDP by the end of 2020, including the addition of 300,000 new jobs, if it is more widely adopted by SMEs that could benefit from it. This figure is higher elsewhere: €12.17bn (£9.73bn) in Italy, €13.48bn (£10.78bn) in France and €18.62bn (£14.89bn) in Germany[41].

- Online receivables exchanges could prove an excellent way of promoting this wider adoption, especially in Germany and France.

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[37] European Commission; Improving opportunities for Initial Public Offerings on growth stock markets in Europe (May 2005); p. 4; http://ec.europa.eu/enterprise/newsroom/cf/_getdocument.cfm?doc_id=1203

[38] http://ec.europa.eu/enterprise/policies/finance/risk-capital/initial-public-offerings/index_en.htm#top

[39] http://www.euf.eu.com/total-factoring-volume/facts-and-figures/total-factoring-volume/menu-id-24.html

[40] *The 'AR Factor': The economic value of Accounts Receivables Finance to Europe's leading economies*; (October 2011);

[41] ibid, pp. 4-5

6. Concluding Remarks

- European SMEs are estimated to have an annual financing gap of between £116bn and £200bn ($188bn to $324bn) that is likely to not be bridged by traditional bank lending.

- We estimate that the UK financing gap could potentially be affecting between c.200,000 and 350,000 SMEs, and its closure could result in the saving/creation of between 370,000 and 670,000 jobs in the UK alone.

- Recently introduced government measures should help in providing better access to funding for SMEs in the UK.

- Non-bank lending is also well placed to play a significant role, especially considering web-based technologies that have emerged in the last decade.

- The UK has a relatively sophisticated market in these new non-bank lending methods, when compared with the rest of Europe.

- However, UK non-bank lending is still small when compared with the scale of the problem the UK faces. More can and should be done by the government to promote these activities.