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The SMEs in the frame of the "Europe 2020 strategy"

The key role of SMEs in the European economy has been repeatedly acknowledged at the highest political level since 2008 when the European Commission released the "Small Business Act" [1]. Following the economic downturn, the European Union has enacted a strategy for "credit easing" conceiving the public support to the financial sector as instrumental for guaranteeing the steady access to credit for firms and especially SMEs.

The need to guarantee SMEs a full access to credit in the achievement of long term stability in the Europe has been further confirmed as one of the main objectives of the "Europe 2020 Strategy" [2], recently published by the European Commission. Among the seven flagship initiatives conceived in order to reach a smart, sustainable and inclusive growth, the European Commission has in fact undertaken "*to strengthen and further develop the role of European Union instruments to support innovation (e.g. structural funds, rural development funds, R&D framework programme, CIP, SET plan), including through closer work with the EIB and streamline administrative procedures to facilitate access to funding, particularly for SMEs*."

SMEs, Supply Chain, and Financing a Global Recovery

The economic dislocation of the past two years has led international corporations, and the banks that support them, to adopt new strategies in how they manage their businesses and maintain competitiveness in a challenging economic environment. Throughout 2009, both the international loan market and the flow of merchandise internationally saw a sharp pullback. In general, companies concurrently faced a decline in business sales and cash inflow as well as a more difficult environment for securing financing. In addition, corporations also began facing concerns about the health of their supply chain. Both the suppliers and buyers/distributors of internationally active companies are often small and medium enterprises (SMEs) that have been facing a similarly challenging environment in terms of sales, inventory levels, liquidity, and financial access. The importance of a healthy supply chain and the interconnectedness of fortunes between multinational companies and their SME partners became clearly apparent during the crisis. One notable example of the symbiotic relationship between suppliers and their larger buyer clients is the automotive sector. The failure of one would so notably affect the fortunes of the other that the US Treasury stepped in to assist small parts suppliers to the auto manufacturers GM and Chrysler. [3]

With this example in mind and going forward in a still fragile recovery, policy-makers, bankers, and CEOs have all realized that the health of SMEs will be an important component of the global economic recovery. The European Commission enacted the Small Business Act in June 2008 with a central component of the legislation being access to finance for small firms.[4] President Obama has placed similar emphasis on the role that SMEs will play in jump-starting economic growth and the need to ensure an increase in SME lending.[5] Global bankers, for their part, have responded to their corporate clients' concern for a healthy supply chain by also developing strategies to assist SMEs. Two of the primary ways that banks do this is through buyer-centric accounts receivable discount programs that provide liquidity to small suppliers and through partnerships with official agencies whose mission is also to support private sector development. Trade bankers have in fact been at the forefront in recognizing their clients' focus on a healthy supply chain and in developing innovative programs that benefit both SME suppliers and international corporations. As governments continue to evaluate ideas to measure the state of the SME sector and develop regulatory frameworks that promote SME growth, banks can play a collaborative role that leverages their experience in promoting efficiencies within the global supply chain and their information base on SME lending practices, demand for SME financing, and pricing comparisons.

Supporting a Global Supply Chain

Starting in the third quarter of 2008 and throughout 2009, international trade flows dropped dramatically. For full-year 2009, the total export and import of goods and services contracted approximately 14% according to World Bank figures. [6] Commercial letter of credit transactions fell by 12.9% in 2008 and by a further 1.4% in 2009, with overall message types falling even more dramatically. [7] This steep drop in letter of credit volume combined with lower international trade figures indicate the difficult business environment that corporations operated in throughout much of 2009. At the same time as business sales became more difficult, access to finance for trade and working capital loans also became a challenge. In the United States, banking assets declined by $302 billion in the first quarter of 2009 [8] while international exposures fell by $6 trillion in the first nine months of the year. [9] In tandem with the volume contraction of international credit markets, shorter tenors and wider spreads characterized many of the loans that all but the largest and most reputable corporations could access. Even as the recovery begins, private capital inflows remain depressed.[10]

Against this backdrop, liquidity and improved working capital management became a major concern of CFOs worldwide. [11] In an effort to improve internal efficiencies and "create" liquidity, companies explored ways to shorter their days sales outstanding (DSO) and lengthen their days payable outstanding (DPO). The difficulty of pursuing this strategy unilaterally, even for firms with the most leverage over their supply chain, is that already fragile suppliers and unhealthy distributors may face collapse at the prospect of squeezing trade terms. The OECD Working Party on SMEs and Entrepreneurship (WPSMEE) has done significant work on the detrimental impact that payment delays have on the working capital position, liquidity, and viability of SMEs. [12] This pressure on supply chain viability is doubly worrisome in the middle of an economic collapse. Corporations, therefore, have been looking to their bankers to assist them in devising solutions that improve their working capital position while also financially supporting their upstream and downstream supply chain. Bankers have responded to this client need by broadening their focus to the SME suppliers and distributors of their large corporate clients. By doing so, banks are hoping to play an important role in creating a win-win situation for global corporations and their SME supply chain partners and in efforts to jump-start lending and merchandise trade. As governments become more active in supporting SMEs as an important component of the global recovery, there is significant opportunity for partnership between the public sector, regulators, and banks to devise a holistic and impactful enabling environment for SMEs.

Implementing SME Solutions

Numerous organizations that specialize in SME development have documented the role that small firms play in creating employment and contributing to GDP growth. In the OECD area, SMEs are estimated to employ more than half of the private sector labor force, with 91% of these enterprises employing less than 10 workers. Similarly, it is well noted that a significant roadblock to an SME recovery is access to financing. [13] While there is no replacement for direct small business relationship lending on the part of regional banks, a concurrent approach to SME financing is being undertaken by global banks in partnership with their large clients. Supplier financing has emerged from the global crisis as the poster-child of trade finance for its impact on the cash conversation cycle and bottom line of global corporations; it carries the potential to be leveraged as a similarly powerful tool in collaborative efforts to jump-start SME access to financing.

Under the supplier finance structure, banks purchase the accounts receivables of SMEs whose buyer is a corporate client. The bank provides immediate cash to the SMEs based on the value of the SME's accounts receivable less a small discount. Upon due date, the bank then collects the full face amount of the accounts receivable from their buyer client. The SMEs receive several benefits from this type of program in addition to the immediate cash infusion. First, programs that use an electronic interface are able to notify the SME as soon as an invoice has been accepted, approved, and scheduled for payment. This visibility enhances an SME's planning capability and provides early notification in the event that there is a trade dispute. Secondly, when an SME discounts its accounts receivables, the receivables are removed from the balance sheet and create space for direct financing from the SME's normal banking relationship.

A number of global banks, including Citi as a leader in this space, have dedicated substantial resources to developing their supplier financing capabilities. This includes the creation of technology platforms that automate the discounting process and enable scaling-up, formation of on-boarding teams that are trained in working directly with SME suppliers to explain the program and help them determine if it supports their business and financing objectives, and due diligence related to cross-border payments and taxation.

Policy makers and development professionals are also recognizing the tremendous opportunity to reach SMEs through the global supply chain and to achieve scale in a shorter period of time. National export credit agencies are exploring opportunities in cooperation with Citi to provide guarantees on the accounts receivables of suppliers whose buyers are exporting firms. Multilateral organizations based in the US and Europe are also in conversations with banks and corporations to offer similar guarantees for SME receivables based on buyer-centric programs. The attractiveness of this approach is that it promotes the cooperation of all stakeholders and has the potential to reach a large number of SMEs in a smaller amount of time. Rather than attempting to identify and assist SMEs across Europe and the United States as an independent exercise, banks and official agencies together can leverage the knowledge base and relationships that already exist between buyer clients and their suppliers.

In addition, public sector companies that procure goods and services from SMEs can also play an important partnership role in addressing the challenges that SMEs face. In the United States, the Prompt Pay Act strives to ensure that government entities do not exacerbate working capital management challenges through payment delays. [14] Despite the relatively short 30 day payment requirement, US public entities are still considering supplier financing programs as a way to add liquidity to the market. The European Commission is also suggesting that public entities provide bill payment within 30-60 days. [15] In addition to these legislative moves, there is potential for banks to work with European public entities on the implementation of supplier finance programs for SME suppliers involved in public contracts. US federal entities are beginning to have discussions in this regard and the learning that has occurred in how to implement these programs in the public sector can be extended to the Euro Area.

Synergies between the banking sector and the EU Institutions in supporting innovation for SMEs

As clarified by the European Commission in the Europe 2020 Strategy, guaranteeing full access to credit to SMEs is crucial in order to enhance innovation and long term stability within the European Union. In the fulfillment of this aim, SMEs should be guaranteed with the effective access to all EU instruments to support innovation, such as structural funds, through closer work with the EIB.

In the shaping of the relevant "financial engineering tools," the EU institutions and EIB may find in the banking sector the complementary structures and competences for the adoption of effective measures to the benefit of SMEs. Supplier finance can be seen as just one of a toolbox of operating political instruments to fill the need for SME liquidity through a very basic but very effective strategy.

Looking Forward

Going forward, it is expected that the supply chain financing market will continue as an important tool in helping global corporations to balance their working capital requirements with the health of their supplier relationships. As this industry begins to mature and more banks enter the market, the continued collaboration of banks, official agencies, and the SME development community as a whole can ensure that SMEs are provided sufficient access to financing and are recognized as a crucial component of the global supply chain and global economic growth.

Banks can also be called upon to play a more important role in promoting visibility into the SME lending sector. Comprehensive data on lending amounts by size of firm, type of lending structures, and pricing spreads are primarily collected through periodic surveys. However, classification and measurement standards are disjointed across markets, making comparisons difficult and data availability an ongoing problem. Banks can be encouraged to mine their internal information in cooperation with other lenders to provide a clearer baseline picture of the SME financing sector and welcome efforts by governments to ensure appropriate disclosure of SME lending practices. Banks may also build on their existing supplier linkages to play a role in helping governments to disseminate information about programs that help SMEs.

It is clear that global banks have invested substantial resources in developing supplier finance offerings that can be used to benefit SMEs and are an important stakeholder in the discussions on SME development. The expectation going forward is that banks can enter the conversation in a more direct way and remain open to new ideas in assisting this crucial business segment long past a global recovery.

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[1] COM(2008) 394 final.
[2] COM(2010) 2020.
[3] In March – April 2009, the US Treasury worked with Citi to implement a $5 billion guarantee program for GM and Chrysler suppliers. Policy makers and financiers were concerned that if the suppliers of GM and Chrysler faced bankruptcy, the supply chain of the auto makers would be severely disrupted and further complicate the recovery efforts of the entire sector.
[4] http://ec.europa.eu/enterprise/policies/sme/small-business-act/
[5] On March 16, President Obama and US Treasury Secretary Timothy Geithner announced that $15B is being committed from the Troubled Asset Relief Program (TARP) to purchase loans backed by the Small Business Administration (SBA). The percentage of guarantee offered by the SBA is also being increased. A final measure of the announcement mandates that the top 21 banks receiving federal funds must report monthly on their lending to small businesses.
[6] Word Bank, Economic Outlook Report, January 2010.
[7] SWIFT Traffic Watch MT7xx.
[8] FDIC
[9] Bank for International Settlements
[10] Institute for International Finance
[11] In 2009, Citi Financial Strategies Group published a report on "Putting Working Capital to Work: Releasing Capital by Accelerating the Cash Conversion Cycle." The research found that shortening the cash conversion cycle can lead to sales growth of 700bps and a typical company can improve ROIC by 84bps by improving working capital efficiency by a quartile relative to its industry.
[12] OECD, "The Impact of the Global Crisis on SME and Entrepreneurship Financing and Policy Responses."
[13] OECD, "The Impact of the Global Crisis on SME and Entrepreneurship Financing and Policy Responses."
[14] http://www.fms.treas.gov/prompt/index.html
[15] Financial Times, "EU Late Payment Law Moves a Step Closer," April 27, 2010.