Scaling-up SME Access to Financial Services in the Developing World

This document is an excerpt of the report ***"Scaling-up SME Access to Financial Services in the Developing World"*** which was developed by the International Finance Corporation (IFC World Bank Group) as the lead technical advisor to the G-20 Financial Inclusion Expert Group's (FIEG) SME Finance Sub-Group

BIIA is raising this topic at the ***Business Information Forum 2011*** (Hong Kong March 24th – at the Hong Kong Convention Centre) to make members aware of the G-20 initiative and to discuss the implication for business information services provider. The purpose of this document is to prepare the discussion team for the special SME session at the BIIA Forum 2011.

Background:

At their September 2009 meeting in Pittsburgh, the G-20 Leaders announced the creation of the Financial Inclusion Experts Group (FIEG), tasked with: (i) supporting innovative modes of financial service delivery capable of reaching the poor; and (ii) scaling up models of small and medium enterprise (SME) financing.

Two sub-groups have been formed, the Access Through Innovation Sub-Group (supported by the Consultative Group to Assist the Poor (CGAP) and co-chaired by Brazil and Australia) and the SME Finance Sub-Group (supported by IFC and co-chaired by Germany and South Africa). In the constituent meeting of the SME Finance Sub-Group on December 3rd 2009, the G-20 FIEG members agreed that the Sub-Group will follow a development agenda on SME Finance, focusing on providing SME Finance solutions for developing countries in particular. A work plan was established and articulated in two tracks:

(i) A stocktaking and scaling-up of best practices in SME Finance; and

(ii) The SME Finance Challenge, a call to the private sector to put forward its best proposals for how public finance can maximize the deployment of private finance on a sustainable and scalable basis.

The Stocktaking Report aims to provide the G-20 Leaders with a summarized but comprehensive framework by which to understand the SME finance gap and its challenges. The first part of the report is conceptual and primarily consists of a review of the literature on SME Finance in the developing world; the second part of the report discusses the analysis of 164 cases of SME Finance interventions compiled through a collective effort involving G-20 member countries, non-member countries, development finance institutions, and private sector players. Finally, the report highlights key recommendations that are proposed to the G-20 Leaders in order to achieve significant and sustainable scale-up of SME access to financial services across the developing world.

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Key Findings:

- ***Small and Medium Enterprises (SMEs) play a major role in economic development, particularly in emerging countries. Studies indicate that formal SMEs contribute up to 45 percent of employment and up to 33 percent of GDP in developing economies***
    - These numbers are significantly higher when taking into account the estimated ***contributions of SMEs operating in the informal sector.*** The informal sector presents one of the greatest challenges in the SME space, with issues that go well beyond finance. In the context of the international development agenda, and given the critical importance of job creation in the recovery cycle following the recent financial crisis, promoting SME development appears to be an important priority.
- ***Access to finance remains a key constraint to SME development in emerging economies***
    - Comprehensive data on the SME finance gap is still to be more consistently collected and monitored over time; however various data sources and studies indicate that small firms rely on internal financing much more than large firms do, and that the likelihood of a small firm having access to a bank loan in low-income countries is about a third of what it is for a medium-sized firm, and less than half of what it is for a larger firm. Other sources of SME finance, such as leasing and factoring, are also less developed in emerging countries.
- ***The total unmet need for credit by all formal and informal MSMEs in emerging markets today is in the range of $2.1 trillion to $2.5 trillion (IFC & McKinsey Study – Two trillion and counting)***
    - A recent study by the IFC and McKinsey suggests that there are close to 365-445 million micro, small, and medium enterprises in emerging markets of which 25-30 million are formal SMEs and 55-70 million are formal micro enterprises, while the rest (285-345 million) are informal SME Definition and Estimates enterprises and non-employer firms. According to the same study, close to 45 to 55 percent of the formal SMEs (11-17 million) in the emerging markets do not have access to formal institutional loans or overdrafts despite a need for one. The finance gap is far bigger when considering the micro and informal enterprises – 65-72 percent of all MSMEs (240-315) in emerging markets lack access to credit. The proportional size of the finance gap varies widely across regions and is particularly daunting in Asia and Africa.

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- ***Closing the credit gap for formal SMEs will be less daunting than for informal SMEs.***
    - Close to 70–76 percent of the formal SMEs (18-22 million) in emerging markets already have a banking relationship via deposit/checking accounts, while only about 30–35 percent of SMEs (8-10 million) have access to credit. Hence the key challenge is to support banks in extending credit facilities to SMEs who have a deposit/checking account, but do not yet have access to credit.
- ***Closing the credit gap for informal SMEs will be a greater challenge***
    - Informal SMEs are far less likely than formal businesses to have existing deposit relationships with financial institutions, and are also far more difficult to serve, especially for commercial banks. Short of comprehensive approaches to move informal businesses into the formal sector, reaching informal businesses will have to build on microfinance approaches, including up-scaling existing microfinance institutions to serve small businesses. As in the case for expanding credit to formal SMEs, this will need to be combined with enhancements to the **enabling environment** for SME lending, including improvements to the financial infrastructure of credit reporting and collateral registries.
- ***The SME finance gap is the result of a mismatch between the needs of the small firms and the supply of financial services***
    - Financial Services are easier for larger firms to access. The SME bankable universe, in which providers are able to meet their expected return on capital, while serving client needs, can be severely limited. This is due to:
        - SME intrinsic weaknesses
        - Flaws in provider delivery models
        - **Lingering deficiencies in the enabling environment for financial services: financial infrastructure (accounting and auditing standards, credit reporting systems, and collateral and insolvency regimes), and the legal and regulatory framework for financial institutions and instruments.**
- ***Deficiencies in the enabling environment and residual market failures have motivated government interventions to foster SME access to financing***
    - Government interventions can be justified in many cases, but research shows that some of these interventions can have mixed results. Little is known about their actual effect on the SME segments in terms of additionality, outreach and sustainability.

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- ***To scale up best practices in SME Finance, the G-20 FIEG SME Finance Sub-Group executed a global SME Finance stocktaking exercise with various SME finance models.***
    - This exercise entailed the collection of 164 SME finance models spanning across a broad spectrum of interventions, including:
        - Legal and regulatory framework
        - Financial information enterprises (credit bureaus, credit reporting companies)
        - Non-employer firms.
    - According to the same study, ***close to 45 to 55 percent of the formal SMEs (11-17 million) in the emerging markets do not have access to formal institutional loans or overdrafts despite a need for one.***
    - The finance gap is far bigger when considering the micro and informal enterprises – 65-72 percent of all MSMEs (240-315 million) in emerging markets lack access to credit. The proportional size of the finance gap varies widely across regions and is particularly daunting in Asia and Africa.
- ***Although SME banking and microfinance models are successfully being rolled out in an increasing number of countries and regions, equity financing remains a challenge in developing economies.***
- ***SME Finance in the developing world has typically been an area of experiment for multiple government support mechanisms***
    - Public support schemes (funded facilities, guarantee schemes, and state banks) represent the large majority of the collected models, a confirmation that support to SME finance is seen as necessary to address weaknesses and possible market failures in this space.
- ***Increasing access to finance can only be successful if qualitative aspects are taken into account***
    - It should be noted that although financial access is critical for SME growth, expansion of financial access should not be achieved at the cost of financial stability. Appropriate prudential measures need to be exercised while offering finance to SMEs, in order to avoid the potential pitfalls stemming from excessive credit.

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FIEG Recommendations:

- ***Financial Inclusion Expert Group's (FIEG) SME Finance Sub-Group makes four key recommendations for the G-20 leaders to implement, in order to achieve a significant and global scale-up of SME access to financial services in the developing world:***

    1. Endorse a set of recommendations for policymakers in the developing world to establish a supportive enabling environment for SME access to financial services in their respective countries by:

        a. Developing country specific diagnostics and strategies;
        b. **Developing a supportive legal and regulatory framework**
        c. Strengthening the financial information infrastructure
        d. Designing effective government support mechanisms;
        e. **Building consistent and reliable data sources on SME finance;**
        f. Building capacity of the financial institutions

    2. Establish a Global SME Finance Forum as a knowledge sharing and monitoring platform to further identify and promote best practices across countries and institutions, establish baselines, and monitor progress.

    3. Scale up previous G-20 successful development interventions in the SME Finance space by setting up a global funding platform to build capacity, provide technical assistance, mitigate risks, and create incentives for the delivery of sustainable and scalable financial services to SMEs, by means of a collaborative effort implemented by its bilateral and multilateral development finance institutions.

    4. Lead the efforts to gather better SME finance data in a coordinated fashion by establishing a platform to consistently collect the cross country data.

BIIA Comments:

- **BIIA's involvement should be proactive:**

    - Working with the IFC (World Bank Group), FIEG and other development organizations in a consultative capacity as they relate to information related activities, standards and regulatory matters (item 1b).

        - For example: Insist on broad mandatory disclosure, registration and compliance requirements. Registered business owners to be considered in the public domain. Access to registers, collateral registers and court information and reuse of such data. Permit data pooling between credit grantors / lenders and information businesses.

BIIA Comments (continued)

- **BIIA members should seek opportunities for expansion:**
  - **Recommendation 1 b) Strengthening the financial information infrastructure**
    - Public credit registries and private credit bureaus. Corporate registers, collateral registers. Insolvency regimes. Legal information systems. Payment and settlement systems. Financial inclusion. Financial advisory and literacy: Services that assist SMEs to manage finance (including trade credit). Accounting standards
  - **Recommendation 1 e) Building consistent and reliable data sources on SME finance**
    - The Singapore SME credit bureau and the Indian SMERA model appear to be one of the more developed role models mentioned in the report, hence the information industry should rise to the challenge by creating appropriate services. Suppliers need to participate in information pooling
    - SMEs are notorious in mingling private and business finance. Access to consumer credit data is essential for providing greater transparency and better risk prediction.
    - Apart from providing credit information for suppliers and the financial services industry, information suppliers need to develop services that help an SME to better manage finances, especially managing trade credit, make accurate credit decisions and manage accounts receivables – risk management platforms, decision support, compliance services
- **BIIA to participate in the SME Finance Forum (item 2)**

The following pages (7 to 10) outlines key points from the IFC and McKinsey article: "Two trillion and counting"

Two trillion and counting

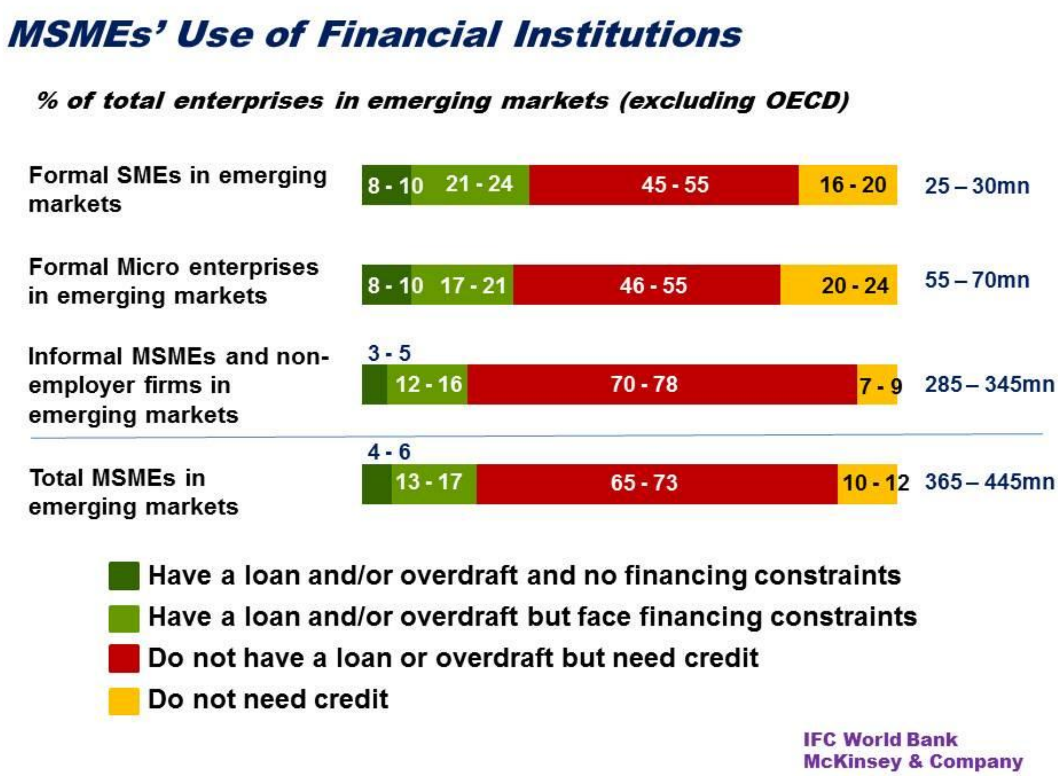
Assessing the credit gap for micro, small, and medium-size enterprises (MSMEs) in the developing world?

The following in an excerpt from a joint effort by the IFC (World Bank Group) and McKinsey & Company) to determine the size of the 'SME credit gap'

The total unmet need for credit by all formal and informal MSMEs in emerging markets today is in the range of $2.1 trillion to $2.5 trillion.

- Micro, small, and medium-size enterprises (MSMEs—enterprises that typically have fewer than 250 employees) contribute significantly to economic development. This is particularly evident in developing countries, where formal MSMEs represent approximately 45 percent of employment and approximately 33 percent of GDP.2 This contribution to economic development is even greater when informal MSMEs—that is, enterprises that are not formally registered—are included.
- The importance of MSMEs to economic development and job creation is increasingly recognized, as suggested by the scale and scope of government interventions designed to encourage them.
- Many countries have resorted or scaled up guarantee schemes during the last financial crisis includes South Korea, Canada, Chile, Germany, the Netherlands and Malaysia. Guarantee schemes are, however, just one of a number of common policy interventions. Other interventions include regulatory and legal steps such as increasing SMEs' access to collateral by reducing barriers to property registry or reducing enforcement costs for lenders and other steps related to improving the amount and quality of financial information about SMEs—for example, by developing credit bureaus. These types of interventions have been common in developed countries for several decades. Governments in developing countries are increasingly implementing them, too.
- **Nevertheless, the total unmet need for credit by all formal and informal MSMEs in emerging markets today is in the range of $2.1 trillion to $2.5 trillion.** In fact, of the estimated 365 million to 445 million formal and informal MSMEs in the developing world, approximately 70 percent do not use external financing from financial institutions, although they are in need of it. Another 15 percent or so are underfinanced. To put this in context, the gap is equivalent to approximately 14 percent of total developing countries' GDP and to about one-third of the current total credit outstanding to MSMEs in emerging markets globally.

- **The authors of the article believe the "credit gap" can be substantially closed, but it will require significant effort from both governments and private institutions.** Governments will need to create the enabling environments and financial infrastructure. Private firms will need to identify economically sustainable approaches to serving MSMEs. Private institutions that implement sound business models will be able to earn billions of dollars in incremental revenues per year, while also contributing significantly to economic development and job creation.



- **Approximately 70 to 76 percent of all SMEs in emerging markets already have a bank account, including 75 to 80 percent of SMEs that have no formal credit (that is, those within the un-served segment).**
  - In fact, 80 to 88 percent of the value of the credit gap for formal SMEs in emerging markets (that is, roughly $600 billion to $730 billion out of $700 billion to $850 billion) comes from SMEs with a bank account.

- Large differences exist among regions. For instance, the credit gap in East Asia ($250 billion to $310 billion) is almost tenfold that in South Asia ($30 billion to $40 billion).

- **Micro and informal enterprises are hard to serve.**
  - They are less likely than formal SMEs to have a preexisting banking relationship, the revenue potential per enterprise for a financial institution is much lower because of these enterprises' smaller size, and these enterprises are more likely to be located in rural or otherwise hard-to-serve areas. **Their lack of formal records or proximity to financial institutions also makes them more expensive to serve than larger, more formal enterprises.** The challenge for governments is to find ways to help informal enterprises adapt and become formal enterprises, and private-sector institutions need to figure out how to innovate business models to serve these enterprises sustainably.
  - There are significant nonfinancial barriers that also constrain MSMEs' growth. Some of the major nonfinancial obstacles identified by MSMEs are infrastructure-related (for example, lack of electricity), regulatory, tax-structure-related, and corruption-related. These nonfinancial barriers are particularly challenging in many developing countries, and are often strongly correlated with the ability of MSMEs to obtain financing. For example, improvements in physical infrastructure typically generate significant productivity gains and improve the prospects for higher rates of returns, thus facilitating access to a wider range of financial services.
  - MSMEs also need *financial* services beyond credit, whether these are transaction accounts, insurance, payments services, or other products and services. Indeed, the potential deposits of MSMEs in emerging markets without bank accounts represent many billions of dollars.

Alternate financing needs:

- Short term: Microfinance - trade financing / factoring
- Medium term: Bank financing and lease financing
- Long term: Private equity (larger firms)

What needs to be done?

- At least three key issues should be addressed:
  1. ***The creation of a more supportive enabling environment*** to promote MSME finance: i.e. lower barriers to serving MSMEs and create incentives for private players to extend their reach to these new markets
  2. ***The need for an improved financial infrastructure:*** i.e. financial infrastructure includes accounting and auditing standards, ***credit reporting systems (credit registries and bureaus)***, **collateral and insolvency regimes, and a well-functioning payments and settlement system.** Improvements in financial infrastructure reduce the opacity and legal uncertainties that increase lenders' risk and thus constrain the supply of finance.
  3. Private-sector institutions efforts to make to meet these enterprises' needs in economically sustainable ways.

Formal SMEs tend already to have bank accounts. This relationship is a rich data source. The approximately 25 million to 30 million formal SMEs that represent between $700 billion and $850 billion of the credit gap offer significant opportunities for banks. To close this gap, financial institutions will largely need to strengthen and optimize their current business models.

Other data sources come as a result of improved infrastructure: Company and collateral registers, payment and settlement systems

Two Trillion and Counting: (pages 7 to 10) is the result of a joint effort of McKinsey & Company and IFC, a member of the World Bank Group.

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