

SME Finance Policy Guide

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GPI

Global Partnership
for Financial Inclusion



IFC

International
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World Bank Group

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List of Abbreviations

AIM	Alternative Investment Market	JSE	Johannesburg Stock Exchange
AML	Anti-Money Laundering	KVIC	Korea Venture Capital Investment Corp
ATMs	Automated Teller Machines	LDCs	Least Developed Countries
BCBS	Basel Committee on Banking Supervision	LGD	Loss Given Default
BDC	Development Bank of Canada	MENA	Middle East and North Africa
BPR	Banques Populaires Régionales	MICs	Middle-Income Countries
CBS	Credit Bureau Singapore	MSE	Micro or Small Enterprise
CCRIS	Central Credit Reference Information System	MSMEs	Micro, Small, and Medium Enterprises
CEDAW	Convention on the Elimination of All Forms of Discrimination against Women	NAFIN	Nacional Financiera
CFT	Combating the Financing of Terrorism	NBFI	Non-bank Financial Institutions
CGAP	Consultative Group to Assist the Poor	NGO	Non-Government Organization
CPM	Crédit Populaire du Maroc	OECD	Organization for Economic Co-Operation and Development
CPSS	Committee on Payments and Settlement Systems	OHADA	Organisation pour l'Harmonisation en Afrique du Droit des Affaires
DCA	Development Credit Authority	PCGs	Partial Credit Guarantee
DFI	Development Finance Institution	PCRs	Public Credit Registries
DLL	Banco De Lage Landen	PD	Probability of Default
EBRD	European Bank for Reconstruction and Development	PE	Private Equity
ECA	Europe and Central Asia	POs	Partner Organizations
EFTPOS	Electronic Funds Transfer at Point of Sale	R&D	Research and Development
EPCGF	European-Palestinian Credit Guarantee Fund	ROSC	Reports on the Observance of Standards and Codes
EU	European Union	SARA	South Asia Regional Apex Fund
FICA	Financial Intelligence Centre Act	SGB	Small and Growing Businesses
FIEG	Financial Inclusion Experts Group	SIYB	Start and Improve Your Business
FINEP	Financiadora de Estudos e Projetos	SMERA	SME Rating Agency of India
FIs	Financial Institutions	SMEs	Small and Medium Enterprises
FOGAPE	Fondo de Garantía para Pequeños Empresarios	TEB	Türk Ekonomik Bank
GEM	Growth Enterprises Market	UNCTAD	United Nations Conference for Trade and Development's Intergovernmental Working Group of Experts on International Standards of Accounting and Reporting
GPFI	G-20 Global Partnership for Financial Inclusion	-ISAR	
GTIP	Global Technology and Innovation Partners	UNCITRAL	United Nations Commission on International Trade Law
IAS	International Accounting Standard	UNIDROIT	International Institute for the Unification of Private Law
IASB	International Accounting Standards Board	USAID	United States Agency for International Development
IFC	International Finance Corporation	VC	Venture Capital
IFRS	International Financial Reporting Standards	WIN	Women in Business
ILO	International Labour Organization		

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Introduction, Context

G-20 and the Global Partnership for Financial Inclusion

The G-20 leaders first committed to improving access to financial services for the poor at their September, 2009, meeting in Pittsburgh. A Financial Inclusion Experts Group (FIEG) was convened to expand access to finance for household consumers and micro, small- and medium-sized enterprises (MSMEs). The G-20 Global Partnership for Financial Inclusion (GPFII) was launched in South Korea in December, 2010. The establishment of the GPFII institutionalized the work by FIEG beyond the Seoul Summit and elevated financial inclusion to a permanent priority within the G-20.

The SME Finance sub-group produced the stocktaking report “Scaling Up SME Access to Financial Services in the Developing World” in 2010. The report included 164 case studies and made policy recommendations in three areas: (1) legislation, regulation, and supervision; (2) financial market infrastructure; and (3) public intervention and support mechanisms. The G-20 SME Finance Task Group, with the support of development agencies and private sector players, committed to support the development and implementation of these SME Finance policy recommendations, through a SME Finance Policy Guide.

A draft Policy Guide for SME Finance has therefore been prepared by the SME Finance sub-group, co-chaired by Germany, Turkey, the United Kingdom, and the United States, with writing and analysis led by the IFC and World Bank, building on the 2010 stocktaking report and informed by further research, consultations, and expert inputs. This Policy Guide therefore provides a comprehensive set of good practice policy measures, recommendations, standards and guidelines, lessons learned, and example models.

SME Finance Stocktaking Report, 2010

The G-20 SME Finance sub-group worked to identify and scale up successful models and policy measures for small and medium sized enterprise (SME) financing through a global stocktaking exercise in 2010. The sub-group collected 164 models of SME finance interventions, covering legal and regulatory approaches, financial infrastructure improvements, public support schemes, and private sector initiatives.

On the basis of the key lessons learned from the 2010 stocktaking exercise, the following recommendations were set out in the report “Scaling Up SME Financing in the Developing World” for establishing an enabling environment for SME access to financial services:

- i) Developing country specific diagnostics and strategies;

- ii) Developing a supportive legal and regulatory framework;
- iii) Strengthening the financial infrastructure;
- iv) Designing effective government support mechanisms;
- v) Building consistent and reliable data sources on SME finance; and
- vi) Building capacity of the financial institutions.

These recommendations are developed here into a Policy Guide, with a focus on policy and regulatory measures. Accepted guidelines and standards are set out, supplemented by examples, models, and diagnostics. Further stock-taking of SME finance models was conducted to deepen insights into the most relevant models, and to try to identify models for all areas of the Policy Guide.

Consultations

A consultative process was fundamental in the development of this Policy Guide. A consultation event “SME Finance, G20 and LDCs: Policy Guide, Challenges and What Works” took place on May 10, 2011, with representatives from LDCs, governments, research institutes, investors, banks, and others, as a side event to the Fourth United Nations Conference on Least Developed Countries in Istanbul. Representatives from LDCs, G-20 countries, international organizations, the private sector, non-governmental organizations (NGOs), academics, and media participated. Consultation briefs for Policy Guide themes and sub-themes were then posted online, together with relevant background documents, for open “virtual” consultations between May 31 and June 24, 2011. The subgroup invited more than 1,000 SME finance experts, practitioners, academics, government officials, regulators, and NGO representatives to join the consultations.

CHAPTER A

Policy Guide: Objectives, Application

The objective of this Policy Guide is to refine and develop the policy recommendations endorsed by G-20 leaders in Seoul in 2010, to take further account of the challenges developing countries face, and to produce a more detailed Policy Guide to guide and support the implementation of SME Finance reforms. The Policy Guide is intended as a guide and reference point for governments and regulators, providing a roadmap for planning, assessing, and implementing policy and legal measures to support SME access to finance.

The draft Policy Guide sets out models and accepted or emerging good practice for policy and legal reforms and public interventions to support SME Finance. As such, it can underpin the development of country action plans and national strategies to improve SME access to finance. Given the mixed results achieved by SME Finance policies, reforms, and interventions in many countries, the Policy Guide incorporates lessons learned, outlines good practice models, and places each Policy Guide component in the context of the issues that it can address, thus offering the potential for tailored, more cost-effective, and higher-impact reforms and interventions.

In line with the guidance received from the G-20 SME Finance co-chairs, there is a focus on Least Developed Countries (LDCs)¹ running through the Policy Guide, including the challenges that LDCs face in supporting SME finance, along with relevant models and recommendations. The challenges faced by the Middle East and North Africa region, including job creation and

widening of economic opportunities, also informed the scope of the Guide as requested by the GPFII co-chairs, with guidance and models provided for public interventions (such as state banks, guarantee funds, apex funds), and a set of policy analysis and recommendations on measures to increase the creditworthiness and competitiveness of SMEs.

The Policy Guide will be presented in draft to the G-20 leaders at the Cannes Summit in November 2011.

Sequencing, Prioritization

The Policy Guide presented in this paper provides a comprehensive menu of interventions to support improved access to finance for SMEs. The significance of market failures, regulatory constraints, supervisory weaknesses, financial infrastructure deficiencies, and financial institution capacity and behavior, will vary by country and context. Therefore, diagnostic assessments are necessary as a first step to inform the selection and sequencing of tools from this Guide.²

The capacity of government to implement reforms, of regulators to effectively introduce and supervise new or reformed regulations, and of the financial sector to respond to an improved enabling environment, will also vary. LDCs in particular may be relatively constrained in terms of human, institutional, and fiscal resources to support comprehensive reform programs, and may need to carefully sequence SME Finance

1 LDC definition and country list in Annex IV.

2 The SME Finance Abatement model is outlined in Annex II. The purpose of the model is to provide a basis on which to calibrate the effectiveness of policy interventions in a country, by first quantifying the SME finance gap, then determining which interventions should be targeted, and assessing the effectiveness and cost of implementing such policies to increase access to finance for SMEs.

policy guides. G-20 partners, including agencies such as the World Bank, IFC, regional development banks, and multilateral and bilateral donors, can play an important role in providing complementary resources to support LDC policy guides.

An enabling regulatory framework and a supportive financial infrastructure are essential in the medium term to encourage sustainable, viable, and significant improvements in access to SME finance. However, in the short term, more direct public interventions may be merited, although these are not without risks in terms of market distortion, the optimal use of using public resources (and the associated opportunity cost), and perverse incentives to financial institutions and SMEs. Public interventions can also be counter-cyclical, as in the case of the recent global financial crisis, or can address more structural market failures.

Data as a Priority

The availability of relevant financial inclusion data is critical for informing the selection, prioritization, and sequencing of elements of the SME Finance Policy Guide set out in this document. The GPFII Data and Target Setting Sub-group identified the following set of gaps in the financial inclusion data landscape, which also merit an initial focus and subsidy on data collection mechanisms from an LDC perspective:³

- i) Gaps related to statistical capacity are those that involve the way in which financial inclusion statistics are measured, collected, and disseminated in general. These are:
 - Some data sets, especially demand-side databases, are not publicly available. In some cases, this is because of confidentiality, in some others, because of transparency or private property.
- ii) Gaps related to financial inclusion dimensions are those that concern input, output and impact indicators. These are:
 - Data and measurement on access to finance by households are more developed than those on access to finance by firms.
 - There is lack of data on informal providers and informal businesses, though it should be acknowledged that data on the informal sector are hard to gather in general.
 - Lack of financial identity weakens the reliability of supply-side data on usage. As users cannot be uniquely identified in forming country-level aggregates in the absence of financial identity, supply-side indicators on usage are prone to multiple counting.
 - Lack of harmonized definitions, standardized data collection and indicator construction—especially for SMEs, active vs. dormant accounts, and demand-side data—lead to challenges with comparability of indicators over time and across countries.

³ Source: "Assessing the Financial Inclusion Data Landscape and the Foundation for Setting Country-Level Financial Inclusion Targets," GPFII Data and Target Setting Sub-group, consultation draft as of September 2011.

CHAPTER B

Access To Finance For SMEs in Least Developed Countries (LDCs)

SMEs play a key role in economic development and make an important contribution to employment and GDP.⁴ Financial access is critical for SMEs' growth and development. In their early stages of development, SMEs rely on internal sources of funding, including the owner's savings, retained earnings, or funding through the sale of assets. As firms start expanding, external sources become more important and their availability can determine the firms' growth possibilities. External finance is positively and significantly associated with productivity. Conversely, financing from internal funds and other informal sources is often negatively associated with growth and firm performance.⁵

However, access to finance remains a key constraint to SME development, especially in emerging economies. Access to finance is disproportionately difficult for SMEs in LDCs, with 41 percent of SMEs in LDCs reporting access to finance as a major constraint to their growth and development, as compared with 30 percent in middle-income countries, and only 15 percent in high-income countries.⁶ Access to finance through bank loans not only decreases with the level of country income, but also tends to be more concentrated among large borrowers. Other common sources of finance for SMEs, such as leasing and factoring, are not yet well developed in LDCs. Annex I presents a statistical overview of access to finance for SMEs in LDCs.

LDCs stand to gain significantly from policy guides that support improved access to finance for SMEs. An

impact evaluation by Banerjee, Abhijit, and Duflo in India in 2008, suggests that credit constraints for Indian SMEs were a leading reason for the productivity and investment gap between the United States and India. There is evidence that, in developing economies, SMEs could contribute more to economic development than they currently do. SMEs tend to be smaller in developing countries, suggesting greater constraints to growth, including financial constraints. Recent World Bank research⁷ using a database for 99 developing countries, found that small firms are important contributors to total employment and job creation, but that small firms also have lower productivity growth than large firms. In other words, while SMEs employ a large number of people and create more jobs, their contribution to productivity and growth is less clear. The authors concluded that growth and increases in productivity require a policy focus on the potential obstacles, which include constrained access to finance and encompass growth capital.

However, LDCs can face a more severe set of challenges in providing enabling policy and legal frameworks for SME finance, relative to middle- and high-income countries that may have stronger institutional capacity and higher levels of access to finance. Financial infrastructure, such as credit information systems, payment systems, and secured transactions and insolvency frameworks, are generally weaker and less developed. LDCs may therefore need to prioritize, adapt, and sequence the Policy Guide components outlined in this paper.

4 Ayyagari, Beck and Demirgüç-Kunt (2007)

5 Beck, Thorsten, Asli Demirgüç-Kunt, and Ross Levine. 2005

6 World Bank Enterprise Surveys. Numbers by income group are simple averages of all countries with data available that fall into the group.

7 Ayyagari, Demirguc-Kunt, Maksimovic (2011)

CHAPTER C

Policy Guide Components

The Policy Guide covers regulatory and supervisory frameworks, financial infrastructure, and public interventions. In addition to the traditional role of ensuring the stability and efficiency of the overall financial system at large, regulators can contribute to greater access to finance by promoting a favorable legal and regulatory environment. Such an environment establishes the rules within which all the financial institutions, instruments, and markets operate in a given country.

This legal and regulatory framework is complemented by a sound financial infrastructure, which improves the efficiency and effectiveness of financial intermediation. A sound payments system and a well-functioning credit information framework are two essential elements of a financial infrastructure. They are crucial to ensure the efficient functioning of financial systems, even in the presence of an otherwise flawless legal and regulatory framework.

In addition to designing and enforcing an enabling regulatory environment and financial infrastructure, governments and regulators may choose to undertake more direct market interventions to promote SME finance. These can compensate for deficiencies in the enabling environment in the interim while reforms are implemented, or address residual market failures, such as enforcement difficulties, imperfect information, protection of depositors, and market power. They include capacity-building for SMEs to improve their creditworthiness, credit guarantee schemes, state banks and funds, and supply chain finance linked to public procurement and payments.

Strategic Approach

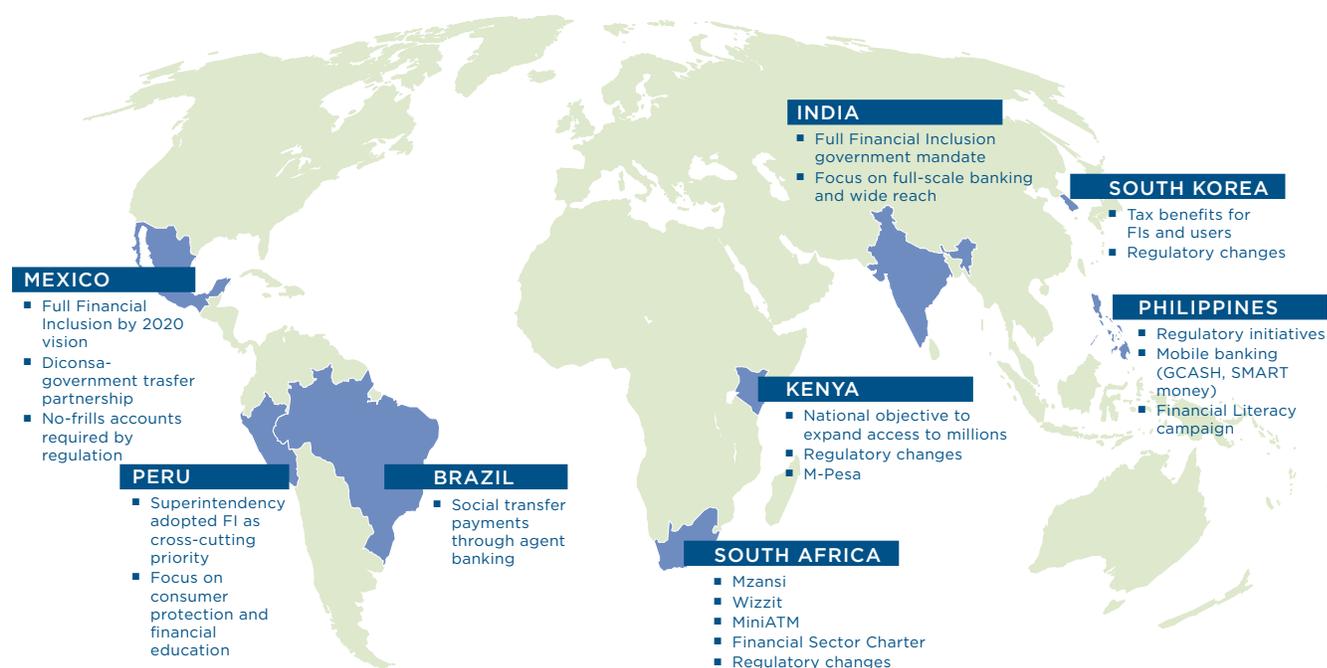
Country-level processes (diagnostics, consultations) are necessary to assess challenges, to identify policy and legal responses from this Policy Guide's menu of options, and to determine lead roles, targets, prioritization, and sequencing. Analysis of the tools and options available, and the potential impact and cost-effectiveness of each, should be conducted before selecting and implementing policy reforms and interventions.⁸ Further work is needed on impact assessment techniques for SME Finance policies and interventions.

WIDER POLICY GUIDE FOR SME FINANCE: FINANCIAL INCLUSION STRATEGIES

Governments and regulators need to take the lead in supporting improvements in access to finance, displaying the leadership called for in the G-20 Principles for Innovative Financial Inclusion. Financial regulators and governments can add financial inclusion as a goal alongside prudential regulation and financial system stability, and develop financial inclusion strategies. The Consultative Group to Assist the Poor (CGAP) and World Bank Financial Access survey (2010) of financial regulators worldwide found that regions that include financial access in their strategies and mandate their financial regulators to carry such agendas are also the countries that reform the most. Regulators with a financial inclusion strategy are more likely to have more financial inclusion topics under their purview, and more resources and staff dedicated to working on these matters.

⁸ The IFC-commissioned SME Finance Abatement model offers a quantitative assessment framework for determining the potential benefits of reforms in reducing barriers to SME access to finance. See Annex II.

FIGURE 1 EXAMPLES OF COUNTRIES ADVANCING FULL FINANCIAL INCLUSION - INCLUDING FOR SMES



Source: World Bank Group Team Analysis and AFI; Map represents selected examples only, not an exhaustive or best practice list of countries with full/universal financial inclusion initiatives. Note that the South Korea example dates back to the credit card lending boom in 1999-2002.

Financial inclusion can be promoted through shared public and private sector goals, developed on the basis of improved market data on financial exclusion. Cooperation with the private sector and civil society (a G-20 Principle) is essential to achieve far-reaching improvements in financial inclusion. Private sector commitments, which may be backed by a threat of regulation or enforcement if the private sector is not sufficiently active in delivering them, can be an effective means of promoting financial inclusion and financial capability. Banks and MFIs can then take a leading role in promoting financial inclusion, spurred on by competition, the threat of regulation, and monitoring, and in line with market opportunities.

Commitments by regulators and governments can complement private sector targets. Charters or codes of practice can serve as the basis for agreements and can set out the financial sector commitments to expanding

access to financial services and to improving the terms of that access. Codes and charters can also encompass consumer education, transparency of information on products, services and tariff structures, complaint handling, and provision of secure and reliable banking and payment systems, backed up by regulations and enforcement where necessary.

On the national level, governments are becoming increasingly more pro-active and some are incorporating financial inclusion, such as SME finance, and the drive to universal access into their national mandate (see Figure 1 for an illustrative map with selected country examples). Recent survey data indicates that at least one aspect of financial inclusion is under the purview of the financial regulators in 90 percent of the economies surveyed. Financial inclusion strategies are increasingly common. SME finance promotion is among the key financial inclusion elements that form

TABLE 1 USING FINANCIAL INCLUSION TARGETS: EXAMPLES

APPROACH	1. Data underpins Reforms and Innovation	2. Public and private sectors agree financial inclusion goals	3. Public sector removes regulatory barriers and monitors progress on goals	4. Private sector develops new financial services and delivery mechanisms
South Africa:	FinScope Data Survey	Financial Sector Charter	Financial Advisory and Intermediary Services Act, Dedicated Banks Bill	Basic bank accounts and mobile phone banking
UK:	Family Resources Survey	Financial Inclusion Task Force	Progress monitored by Financial Inclusion Indicators	Basic Bank Accounts, Financial services through Post Office
Canada:		Canadian Banking Code	Financial Consumer Agency of Canada	Low cost bank accounts
India:		Banking Codes and Standards Board of India	Reserve Bank of India's guidance on Financial Inclusion	Basic bank accounts, Innovative use of technology to reach customers

Source: Pearce & Bajaj, 2006.

part of governments' strategies or mandates. Other elements include: consumer protection, financial literacy, regulation of microfinance, savings promotion, and SME finance promotion.⁹

India has mandated financial inclusion as a national goal. The Reserve Bank of India has intensified a number of measures and endorsed quantitative access targets over the last year to further financial inclusion. The government of Mexico is welcoming and supporting ongoing financial inclusion programs and analytical work to advance the goal of full financial inclusion by 2020. South Africa has mobilized the public and private sectors to design products and interventions that serve as the entry-level point, to include a larger percentage of the unbanked in formal financial services (e.g., Mzansi accounts with no monthly fee and no minimum balance). Moreover, the United Nations committee on building inclusive financial sectors, set up in 2006, urged central banks and governments to add the goal of

universal "financial inclusion" to the two traditional goals of prudential regulation: safety of depositors' funds and the stability of the financial system.¹⁰

Country-level goals regarding financial inclusion have varied in their focus. Countries can choose whether to focus on a general goal or a specific target. In addition, goals and targets can be either general or specific to households or SME finance, depending on the level of development and prioritization each country determines most appropriate after conducting a systematic, data-driven diagnostic. An example of specific targets for SME access to finance is outlined in the box on page 13.

DATA TO UNDERPIN SME FINANCE POLICY GUIDES¹¹

As a first step to developing country level action plans and targets, governments should emphasize improving

9 CGAP and World Bank Group. "Financial Access" database.

10 UN, "Building Inclusive Financial Sector for Development", 2006, India, Mexico and South Africa examples based on public reports and publicly available information. Section excerpted from Randhawa et al. (2010).

11 For further details, see the GPFI Data and Target Setting Sub-group report: "Assessing the Financial Inclusion Data Landscape and the Foundation for Setting Country-Level Financial Inclusion Targets," GPFI Data and Target Setting Sub-group, consultation draft as of September 2011.

SME LENDING TARGETS IN THE UNITED KINGDOM

In February 2011, the Merlin Agreement was established between the UK Government and the major UK banks – specifically Barclays, HSBC, LBG and RBS, and Santander – recognizing their responsibility to support economic recovery in the United Kingdom. The agreement sets lending targets of around £190 billion this year, including £76 billion to small firms. The Bank of England will monitor whether the loans targets are being met. This is part of a wider agreement that also includes curbs on bonuses and requirements to disclose salaries, and has been negotiated as a result of the banking sector bailout that occurred in the context of the crisis.

The banks are also committed to implementing the recommendations of the UK Business Finance Taskforce (which also comprises Standard Chartered), in particular the following;

- i) Support a network of mentors from the banks, attached to existing mentoring organizations, to deliver a free finance service to small and medium sized businesses across the United Kingdom;
- ii) Improve service levels to micro enterprises through a new lending code;
- iii) Publish lending principles that clearly set out the minimum standards for medium-sized and larger businesses;
- iv) Establish transparent appeals processes for when loan applications are declined, with processes independently monitored by a senior independent reviewer, who will publish the results of their review;
- v) Initiate a pre re-financing dialogue 12 months ahead of any term loan coming to an end;
- vi) Establish and invest in a new £1.5 billion Business Growth Fund (built over a number of years);
- vii) Support the Enterprise Finance Guarantee Scheme;
- viii) Help mid-sized businesses access syndicated debt markets;
- ix) Improve access to trade finance;
- x) Signpost alternative sources of finance;
- xi) Fund and publish a regular independent survey on business finance demand and lending supply;
- xii) Enhance the cross-industry lending dataset by broadening the statistics on (among other things) lending to deprived areas and national and regional data on the provision of bank support to business start-ups
- xiii) Hold regional outreach events throughout 2011;
- xiv) Improve customer information including a review of literature and other materials (e.g., loan applications); and
- xv) Establish a Business Finance Round Table.

Source: http://www.hm-treasury.gov.uk/d/bank_agreement_090211.pdf

data availability and investing in regular collection and dissemination of reliable financial inclusion data. The focus of these data-related investments will vary by country, but overall recommended measures to improve the current data landscape on SME finance are the following:

- Harmonize the definitions of the concepts to be measured to ensure comparability across countries and over time, to devise development strategies, and to adapt or design informed policies. This is especially important for data and measurement of access to finance by SMEs and women-owned SMEs.¹²
- Standardize data collection and indicator computation. The use of international concepts, classifications and methods promotes the transparency, consistency and efficiency of statistical systems.
- Build or improve national statistical capacity to improve data availability and quality.
- Improve data availability and quality with a focus on missing indicators including barriers to access, usage by enterprises, role of informal providers, etc.
- Build consistent and reliable data sources for access to finance by agricultural SMEs.¹³
- Ensure open data access.

¹² Also see “Strengthening Access to Finance for Women-Owned SMEs in Developing Countries: Executive Summary for GPF Report” prepared by IFC for the GPF SME Finance Sub-group, August 2011.

¹³ Source: “Policy Paper on Agricultural Finance for Small and Medium-Sized Enterprises: Executive Summary for GPF Report” prepared by IFC for the GPF SME Finance Sub-group (August 2011).

The following high-level aspirations are recommended as an overall guide when embarking upon the challenging task of developing country-level targets:

- Country ownership and commitment.
- Encompass the definition of full financial inclusion.
- Take into account how countries' differing starting points affect what is realistic and aspirational for target setting.
- Targets should be determined through data-driven and evidence-based methodology.

Building inclusive financial systems is a multi-stage journey, and different types of indicators are suitable for different stages of this journey. The stages of this journey may not necessarily be sequential, but some may overlap with one another; however within each stage, it is possible to consider indicators grouped into three as input, output and impact. Input indicators describe the key characteristics of the enabling environment such as public sector driven enablers, macroeconomic descriptors or private sector drive, output indicators capture consequences of input actions such as access, usage, and quality, and impact indicators measure improvements in well-being such as firm profitability due to financial inclusion policies.

G-20 PRINCIPLES FOR INNOVATIVE FINANCIAL INCLUSION

A starting point for triggering country-level development is to develop key principles that can guide actions at a high level. The national leaders at the G-20 Toronto Summit, in June 2010, adopted the nine “Principles for Innovative Financial Inclusion.” These principles for innovative financial inclusion outline some of the key steps necessary to create an enabling policy and regulatory environment for improved financial access. The principles derive from the experiences and lessons learned from policymakers throughout the world, especially leaders from developing countries.¹⁴ They are directly applicable to

many aspects of SME finance, and cover leadership, diversity, innovation, protection, empowerment, cooperation, knowledge, proportionality, and regulatory framework.

C.1. Regulatory and Supervisory Frameworks

The legal and regulatory framework establishes the rules within which all the financial institutions, instruments, and markets operate in a given country. It includes banking, insurance, leasing, factoring, and security laws, as well the respective bodies of secondary regulations and guidelines. Sound legal and regulatory frameworks that are effectively enforced promote market development and competition, while subjecting financial institutions and agents to sound and appropriate prudential regulation and rules of conduct in order to protect consumers and depositors as well as to ensure market stability. Thus, several objectives need to be balanced, of which access to finance is one.

C.1.1. ROLE OF REGULATORS

The primary role of regulators is to ensure the efficient regulation and supervision that is essential to a well-functioning economy and that underpins economic, social, and environmental objectives. The financial system in particular cannot operate without a range of comprehensive regulatory frameworks, including those that establish accounting, auditing, legal, and judicial systems, as well as sector-specific requirements such as prudential regulation. Regulation that is properly designed and implemented helps the financial system to function as intended. In this context, high-quality regulation may be defined as that which produces the desired results as cost efficiently as possible. The two main components of this definition are that regulation succeeds in achieving the intended objective (i.e., it is effective) and does so at reasonable cost (i.e., it is efficient).

14 “Innovative Financial Inclusion: Principles and Report on Innovative Financial Inclusion from the Access through Innovation Sub-Group of the G20 Financial Inclusion Experts Group”, May 25, 2010.

Regulators and supervisors play a key role in the design and implementation of an enabling environment for SME finance, which includes providing the legal and regulatory framework in support of SME access to finance, and can also include interventions promoting SME finance, and the collection and analysis of data on financial inclusion. While data collection can support the prudent development of SME finance through enabling effective supervision of expanding provision of financial services, and through providing much needed market data to financial institutions, other regulatory measures have risked distorting markets or have been counterproductive.

For example, interest rate ceilings designed to make finance more affordable may actually depress SME lending volumes, while directed lending, for example through requirements for banks to set up branches in rural areas or to lend to certain SME sectors, can add costs and risks for SME lending. Exemptions on reserve requirements have been used to try and stimulate SME lending, and in some cases to lower the interest rates for SME borrowers. For example, the Egyptian central bank waived its 14 percent reserve requirement on loans to SMEs, for an amount equal to the SME lending of each bank. The Jordanian central bank also reduced reserve requirements for an amount equivalent to SME lending, on the condition that banks lent at a lower rate (relative to the prime rate) to SMEs.

Standards, guidelines, good practice

The policy and regulatory framework should be proportionate with the risks involved in such innovative products and services, and is based on an understanding of the gaps and barriers in existing regulation. Under a proportional regulatory framework, regulatory requirements vary with the benefits and risks associated with a financial service or the provider of the financial service. The aim should be for regulatory policies that enable, rather than inhibit, appropriate innovation in connection with regulated activities in a

way that manages risk. The challenge lies in tailoring regulation to mitigate the risks of specific types of services and delivery approaches without imposing an undue regulatory burden that could stifle innovation. Proportionality in regulation can be accomplished, for example, by setting different requirements correlated with the differing levels and types of risk involved in different activities. Regular, thorough diagnostic exercises that identify the gaps and barriers in current policy and regulation should inform sound innovative financial inclusion policy formulation, as the experiences of Argentina, Russia, and Mexico demonstrate. Such reviews are important because the barriers and gaps in existing regulation that prevent innovative financial inclusion reaching scale rapidly, yet safely, are not necessarily obvious.

While designing and enforcing an enabling environment and intervention mechanisms in support of SME access to finance, regulators need to keep overarching objectives in mind: ensuring the stability of the financial system, promoting financial literacy and consumer protection, and respecting Anti-Money Laundering (AML) and Combatting the Financing of Terrorism (CFT) regulations. The pursuit of these objectives can involve trade-offs with measures aimed at widening access to finance. The design of access to finance reforms needs to be balanced with these overarching objectives in mind, and the South Africa example on page 17 illustrates how this can be achieved in an emerging market.

Regulators can also collect and evaluate data on SME access to finance, building on credit registry and other reporting data that they do or could collect. Financial inclusion data is critical in supporting evidence-based policymaking, helping inform the prioritization of efforts, and tracking progress of the proposed targets. Without standardized, comparable, and regularly updated data at the global and national level, progress tracking and target setting is sub-optimal and lacks direction. Thus, data and measurement is a key and indispensable area of work that requires: i) defining measurable financial inclusion

GENERAL GOOD PRACTICES FOR AN EFFECTIVE AND EFFICIENT FINANCIAL REGULATORY PROCESS

Good practice regulation making process is comprised of four main steps.

First, policymakers should make the case for regulatory intervention. This involves:

- defining the regulatory philosophy and establishing proper policy objectives;
- establishing an open and transparent regulatory decision-making process; and
- comprehensively analyzing the market failure to identify and define the issue to be addressed and determine whether there is evidence that government action is justified.

Second, policymakers should design and implement appropriate policy measures by:

- identifying measures that address the problem as identified, including non-regulatory measures and the status quo;
- assessing the benefits and costs of each alternative policy proposal, preferably through a formal and structured regulatory impact assessment; and
- designing and implementing the chosen regulatory solution while taking account of issues including clarity, consistency, proportionality and accountability.

Third, to guarantee the success of policies, authorities should design effective enforcement strategies, preferably by leveraging off existing incentive structures. Enforcement measures should be fair and transparent and well-integrated in the overall regulatory decision-making process.

Finally, policymakers should conduct ex-post evaluation, to determine whether the regulation remains relevant in its current form or if its goals could be better achieved in another way. Less frequently, the entire regulatory framework, including the underlying regulatory philosophy, should also be reviewed.

G-20 Financial Inclusion Experts Group—ATISG Report p.20

dimensions; and ii) improving current and developing existing data collection efforts and indicators towards the goal of establishing an international financial inclusion data platform.

An example of directed lending requirements is outlined on page 17, for insights into the use of directed lending for SME finance and its potential harmful impacts on lending costs and risks.

Challenges and Priorities for Least Developed Countries

One of the largest challenges faced by LDCs is the weak capacity of the regulatory and supervisory bodies. Central banks and financial market authorities often struggle to perform their main regulatory and supervisory tasks due to the lack of adequate financial and human resources. Adding additional responsibilities (e.g., monitoring SME finance) or expanding their coverage (e.g., covering microfinance institutions, non-bank financial institutions, etc.) may represent a

capacity challenge that limits the effectiveness of those reforms.

The lower levels of regulatory and supervisory capacity particularly common in low-income jurisdictions suggest the need for careful prioritization of the most important challenges to be addressed and the most promising opportunities to be seized. Regulators of LDCs may also face challenges to adopt a “proportionate” regulatory or supervisory approach (or a “risk-based approach”). LDCs may not currently have the capacity to implement a proportionate, or risk-based, approach, which requires more human resources, information, and financial resources. Instead, they may prefer to start with a basic institutional framework that is more compliance or rules-based, while gradually shifting to a more sophisticated regulatory framework over time as their markets and regulatory and supervisory capacity develops.

FINDING THE RIGHT BALANCE BETWEEN FINANCIAL ACCESS AND AML/CFT REGULATION: THE CASE OF THE SOUTH AFRICA

South Africa: In South Africa the Financial Intelligence Centre Act (FICA) and its regulations determine the AML/CFT obligations of financial institutions. The Act provides that an accountable institution must keep a record of the identity of the client and any documents obtained in verifying that identity. Two requirements of the FICA regulations were subsequently identified as potential obstacles for customers in the low-income market: (i) a national identity document to verify personal details, and (ii) documentary proof of residential address when opening a bank account. Approximately one-third of adult South Africans, many of whom live in informal housing, could not provide such documentary proof of residential address.

- In 2002 an exemption was issued eliminating the need to obtain and verify address details, and relaxing record-keeping requirements for accounts and services subject to balance and transaction limits.¹⁵ Further refinements in 2004 supported a basic bank account (“Mzansi”) and related payment services. To date, more than six million such accounts have been opened.
- In 2006, the South African Reserve Bank allowed banks to open mobile phone-operated bank accounts (within certain transaction and balance limits) without having to undertake face-to-face customer due diligence and with even lower transaction limits.¹⁶

LESSONS FOR SME BANKING IN INDIA: PROMOTING BRANCH EXPANSION TO UNDERSERVED AREAS

Between 1977 and 1990, the Reserve Bank of India mandated that a commercial bank could open a new branch in a location that already had bank branches only if it opened four in locations with no branches. This regulation was part of a social banking program that tried to expand access to financial services in rural areas. An ex post evaluation of this policy¹⁷ shows that it had sizable effects. The 1:4 rule was a binding constraint on banks and, together with a regulated branch-level loan-deposit ratio of 60 percent, led to an increase in bank branches and in rural credit in less densely banked states, even after controlling for other state characteristics that might have driven branch and credit expansion.

But there was a significant downside: commercial banks incurred large losses attributable to subsidized interest rates and high loan losses—suggesting potential longer-term damage to the credit culture. Furthermore, many governments do not have the carrot of licensing branches in markets as dynamic as those of some of the largest Indian cities to compensate for the stick of compulsory rural branches.

Finance for All, World Bank, 2008

15 The balance may not exceed ZAR 25,000 (approximately US\$3,400); the daily transaction limit is ZAR 5,000 (approximately US\$680), and the monthly limit is ZAR 25,000 (approximately US\$3,400).

16 The transactions on such an account are limited to ZAR 1,000 (approximately US\$135) per day. If clients wish to exceed this limit, a face-to-face confirmation of the client’s identity must be carried out in accordance with the provisions of Exemption 17. Some industry participants argue that the caps in Guidance Note 6 are too low and should be adjusted upward to facilitate market development.

17 Burgess and Pande (2005)

C.1.2: BASEL II/III AND SME FINANCE

Basel II is a framework providing harmonized rules for the calculation of regulatory capital measures. The purpose of Basel II, which was initially published in June 2004, was to create an international standard determining the amount of capital banks should put aside to guard against the types of financial and operational risks they face. Capital requirements ensure that financial institutions have sufficient capital to sustain operating losses while still honoring withdrawals, and thus help protect the international financial system from the types of problems that might arise should a major bank or a series of banks collapse.

During the consultation period on Basel II, some empirical studies supported claims that the more risk-sensitive nature of Basel II would reduce the availability and increase the cost of finance for SMEs, in particular unrated SMEs, as banks would be required to hold relatively more capital for SME exposures. In response, the Basel Committee made some specific changes to the final version in order to accommodate SME Finance. These changes include: (i) at a given probability of default, exposures to SMEs were to require relatively less capital than larger firms in risk-weighting calculations; (ii) SME exposures classified as retail were to have a specific risk weight curve; (iii) the risk weight for non-mortgage retail exposures was reduced under the standardized approach; and (iv) credit risk mitigants such as collateral and guarantees were better recognized. The debate on the impact of Basel II on SME Finance has abated since the release of the final version of the Basel II Framework. The changes largely succeeded in addressing the main concerns about the potential impact of Basel II on SME Finance, and the impact studies of the Basel Committee have suggested that, broadly speaking, capital requirements for SMEs would not be significantly higher than those under Basel I.

Basel III is a new global regulatory standard on bank capital adequacy and liquidity agreed by the Basel

Committee on Banking Supervision (BCBS) in response to the deficiencies in financial regulation revealed by the global financial crisis. Basel III strengthens further the bank capital requirements that were introduced under Basel II and introduces new regulatory requirements on bank capital, liquidity, and bank leverage. It will be phased in over the period 2011-2019.¹⁸

During the consultations on the preparation of this Policy Guide, some concerns were raised about the impact of Basel III on banks' ability to lend to SMEs, although the gradual implementation of the new rules through 2019 give banks time to adjust to the new capital requirements. The argument was made that the new capital requirements, liquidity requirements, and leverage ratio all could potentially reduce banks' ability to lend to SMEs, and that an objective assessment on the Basel III impact on SME lending is necessary. It was noted that there was no clear indication that the leverage ratio, liquidity requirements, or increase in capital levels will have a particular effect on SME lending, and that the credit risk framework regarding SME portfolios has remained unchanged. The increased capital requirements will raise the average costs of banks' liabilities, which could raise the interest rates charged to bank clients, including SMEs.

Standards, guidelines, good practice

Regulators from 25 African central banks noted the following at a workshop on the Implementation of International Standards for Banking Supervision and the Basel Capital Framework, in Uganda, April 2011:

- International standards provide an important orientation and point of reference for the long-term reform agenda, but should not be seen as blueprints for the reform process in African countries. Maximizing regulatory effectiveness and financial stability under resource constraints requires appropriate sequencing and prioritization of building blocks of financial regulation and supervision. Rather than adopting international standards wholesale, African regulators need to judge which elements of the standards could

18 For further information see: <http://www.bis.org/bcbs/basel3.htm>

provide useful and effective building blocks within the current country and regional context.

- While many African countries intend to move to adopt the Basel II capital framework the focus should be on implementing the supervisory processes outlined under Pillar 2 and Pillar 3. The importance of enhancing supervisory capacity as a precondition for adopting the more complex rules under the Basel capital framework was emphasized. Further, it was recognized that the adoption of Basel II does not constitute a necessary precondition for the implementation of important elements of Basel III. Financial stability might better be achieved by focusing on increasing supervisory capacity and adding those provisions from the new Basel III framework that are of higher immediate importance for African financial systems.

Challenges and priorities for LDCs

Basel II was primarily aimed at “internationally active banks.” Many developing country supervisors are still struggling with the core principles, as well as with problems relating to capacity, independence, legal protection, and more. To accommodate smaller banks with less sophisticated risk management systems, approaches for a simpler and more prescriptive risk management system similar to Basel II were developed. However, banks in developing countries will also be subject to more stringent capital requirements (with greater reliance on core tier capital), leverage ratios, and other rules being proposed at the international level by the BCBS if they choose to implement Basel III. This should not pose an immediate problem, as emerging country banks are generally better capitalized and less leveraged than banks in developed countries, but these banks will need to build up more capital in order to meet the growing needs of their economies, including the demand for credit by SMEs. Emerging country banks will also need to strengthen their risk governance in line with the more stringent standards being currently proposed by the BCBS.

Recommendations regarding the implementation of Basel II in developing countries, with particular reference to the effects on SME development, include:¹⁹

- It is advisable that LDC regulators proceed cautiously in implementing Basel II.
- Political support may be needed for implementation, so that LICs do not rush to implement the more complex approaches, which are favored by the international banks.
- LIC regulators need to carefully assess the broader implications of Basel II, for banking stability, for credit policy, for access to credit for SMEs, and on competitiveness of national versus international banks.
- Higher levels of technical assistance to LICs are necessary.
- Regional collaboration is desirable, in the mode of the Caribbean Group of Securities Regulators, allowing for the possible development of a uniform approach, and forging a common position on specific issues.
- Other more detailed recommendations on prudential regulation and supervision are set out in the 25 Basel Core Principles for Effective Banking Supervision.
- Capacity problems, issues related to consolidated supervision, independence of the supervisor, legal protection for supervisors, and other issues need to be addressed.

Most of the Basel III measures proposed are of limited immediate relevance to African banking sectors, since the weaknesses they address are largely a result of regulatory philosophies and market practice in developed markets. Basel III outlines various measures to raise the quality, consistency, and transparency of the regulatory capital base, focusing largely on the definition of Tier 1 capital. In most African states, bank capital structures are a relatively straightforward composition of common shares and retained earnings and thus already fulfill Basel III quality requirements.

C.1.3: ENABLING REGULATORY FRAMEWORKS FOR ALTERNATIVE SME FINANCE PRODUCTS: LEASING, FACTORING

Improvements in access to finance for SMEs do not depend on banks alone, as they can be achieved through a range of non-bank financial institutions (NBFIs) as well. NBFIs of different types provide a wide range of services, including: hire purchase transactions such as leasing of machinery or equipment; the factoring or discount purchasing of accounts receivable and other forms of supply chain finance; and new equity to invest in companies. Provision through NBFIs can be enhanced by reforming tax, legal, and regulatory environments, and by supporting the introduction of technological platforms that support a wider variety of financial products and services to be developed, drive down the costs of financial access, and reach previously untapped markets.

Factoring is an important source of working capital finance for SMEs, especially in jurisdictions where the financial infrastructure is deficient. Factoring entails the purchase by the lender of a firm's accounts receivables at a discount and, in the case of non-recourse provisions, the collection of invoices directly from the parties that owe money. Factoring addresses the problem of SME opacity by focusing on the quality of the obligor; in effect, a risky supplier can transfer its credit risk to that of a higher quality buyer. In recent years, a variation referred to as reverse factoring, or "supply-chain financing," has become a popular financial instrument. With reverse factoring, the financial institution purchases receivables only from high credit quality buyers rather than a portfolio of all buyers of specific sellers, resulting in the provision of low-risk loans to high-risk suppliers (SMEs). Reverse factoring is particularly useful for SMEs in countries with under-developed contract enforcement regimes and weak credit information systems.²⁰

Likewise, leasing appears as an important complementary source of investment finance, particularly in countries where the information infrastructure is weak. A potential advantage of leasing lies in the fact that it focuses on the firm's ability to generate cash flows from business operations to service the leasing payment, rather than on its credit history or ability to pledge collateral.

Standards, Guideline, Good Practices

Leasing:

The IFC provides detailed guidelines for emerging economies on developing the leasing sector.²¹ A legislative framework for leasing should:

- Clarify rights and responsibilities of the parties to a lease;
- Remove contradictions within the existing legislation;
- Create non-judicial repossession mechanisms; and
- Ensure only the necessary level of leasing industry supervision and licensing.

Strengthening the legal framework for leasing can be achieved through a specialized leasing law combined with appropriate changes in related pieces of legislation. Among others, the definition of leasing needs to be clear and a fair balance established between the rights and responsibilities of the parties to a lease. It is important to establish regulations for other forms and types of leasing, such as sale and lease-back and sub-leasing. In addition, a leasing law should address the following elements:

- First, the process for registering leased assets should be strengthened. One of the first priorities entails the development of registries in which lessors may publicize their interest in the leased asset and protect its ownership rights. Ideally, there should be a unified registry for movable collateral where all security interests are recorded, with the lessor's interests in leased assets recorded.
- Second, repossession procedures may need to be defined and enforced. The right of the lessor (as owner)

20 Klapper (2005); IFC Board paper on Warehouse Receipt Financing and Supply Chain Financing, 09.09.2010.

21 Fletcher et al., (2005) "Leasing in Development: Guidelines for Emerging Economies", IFC, available at: [http://www.ifc.org/ifcext/sme.nsf/AttachmentsByTitle/Leasing_in_Dev_Nov05.pdf/\\$FILE/Leasing_in_Dev_Nov05.pdf](http://www.ifc.org/ifcext/sme.nsf/AttachmentsByTitle/Leasing_in_Dev_Nov05.pdf/$FILE/Leasing_in_Dev_Nov05.pdf)

to repossess a leased asset expediently should not depend on the type of breach committed by the lessee.

- Third, tax rules should be clear and neutral, removing any bias against leasing. The income tax treatment of leasing and loans should be similar, as there is little difference between leasing and loan finance, and value added tax rules should clarify that a leasing operation is a financial service, not the sale of a good or a rental.
- Fourth, insolvency regimes must clarify the rights of lessors and lessees under bankruptcy. The consequences of default should be clearer. In particular, lessors' rights under bankruptcy should be preserved, as lessors are a particular class of secured lender – leased assets do not belong to the insolvent company and should be returned to the owner (the lessor).

The IFC recommends that International Accounting Standard (IAS) 17, on Leases, is used as a basis for the definition of local leasing legislation, including accounting for leases. IAS-17 provides a useful framework and guidelines for the development of domestic leasing legislation. While the application of IAS may not be common to all countries, the adoption of IAS is a target for most countries. With this in mind, using IAS-17 as the basis for local leasing legislation, it is possible to build in a quality standard for that legislation. IFC also recommends that leasing be classified as an investment activity and a financial service, because it is

important for leasing to operate on the same level playing field as other forms of credit.

Supervision of leasing by central bank structures should be determined based on country-specific factors. If the lease is financed by an institution that is already under central bank supervision, supervision by central bank structures would be prudent. While establishing minimum capital requirements for leasing institutions might help weed out inadequately capitalized leasing companies, this restriction may also inhibit the development of the leasing industry, particularly in nascent markets where it may be slow to develop. Hence, the establishment of obligatory capital requirements for leasing calls for careful evaluation in the context of the existing legal and regulatory framework, as well as other factors.

To increase the volume of lease transactions in LDCs, IFC Advisory Services has created a leasing program in Africa designed around three core products that are provided individually or as part of a package depending on country needs: i) entry-level advisory services addressing legislative and regulatory constraints for leasing, including tax issues at regional and country level; ii) value added advisory services by partnering with international experienced leasing technical partners to provide know how transfer, capacity building, and financing; and iii) mobilization of investment capital by addressing the availability of medium- to

FOSTERING SME LENDING THROUGH LEASING

Jordan's Ministry of Industry and Trade, in coordination with IFC, introduced an initiative in 2006 with the objective to improve the leasing environment in Jordan, and to promote and increase the volume of leasing activities. The project's main activities include: (i) provide support to policymakers to draft, lobby, and promote leasing legislation based on best practices; (ii) build capacity of leasing stakeholders (e.g., FIs, equipment suppliers, investors) through consultations and training; (iii) increase awareness of benefits of leasing to SMEs to finance business assets; and, (iv) promote and facilitate leasing investments.

As a result of the initiative, four laws were introduced: Law on Leasing, Movable Leased Assets Registration Instructions, and Registration Instructions for Leased Vehicles and Internal Procedures for Land Registration. Financial leasing has become more favorable and the leasing market has grown substantially.

Source: G20 Stocktaking Report, 2010

long-term capital to fund leasing operations in the region by facilitating partnerships between technical partners and prospective local and international investors interested in the leasing market.

Factoring:

Can be a powerful tool in providing financing to high-risk, informationally opaque sellers, which are often SMEs. Factoring's key virtue is that underwriting is based on the risk of the receivables (i.e., the buyer) rather than the risk of the seller. Therefore, factoring may be particularly well suited for financing receivables from large or foreign firms when those receivables are obligations of buyers who are more creditworthy than the sellers themselves. Factoring can provide important export services to SMEs in both developed and developing countries. Like traditional forms of commercial lending, factoring provides SMEs with working capital financing.

Factoring only requires the legal environment to sell, or assign, receivables and depends relatively less on the business environment than traditional lending products. Another merit of factoring in a weak business environment is that the factored receivables are removed from the bankruptcy estate of the seller and become the property of the factor. In this case, the quality and efficacy of bankruptcy laws are less important.

However, factoring may still be hampered by weak contract enforcement institutions and other tax, legal, and regulatory impediments. For example, factoring generally requires good historical credit information on all buyers; if unavailable, the factor takes on a larger credit risk. In general, a small firm sells its complete portfolios of receivables in order to diversify its risk to any one seller. In fact, many factors require sellers to have a minimum number of customers in order to reduce the exposure of the factor to any one buyer and to the seller's ability to repay from receipts from other buyers, in the case that a buyer defaults. However, this diversified portfolio approach requires factors to collect credit information and calculate the credit risk for

many buyers. In many emerging markets the credit information bureau is incomplete (i.e., may not include small firms), or non-bank lenders, such as factors, are prohibited from joining. In the case of exporters, it might be prohibitively expensive for the factor to collect credit information on firms around the world.

Factoring has developed in a variety of legal and regulatory settings, specific to the individual country in which the factoring is provided. Points of reference and guidance for legal reforms to encourage factoring include the United Nations Commission on International Trade Law (UNCITRAL), and also the International Institute for the Unification of Private Law (UNIDROIT) convention of 1988.

Challenges and priorities for LDCs

Many LDCs face structural obstacles in developing a leasing industry, including the absence of clearly defined and predictable laws and regulations governing leasing transactions, unclear accounting standards, the lack of an appropriate tax regime, or constrained funding. Introducing leasing as an alternative source of equipment finance for enterprises promotes the development of domestic financial markets and encourages competition and efficiency for sustainable financial market growth. It is a relevant product to support investments in the real and service sectors, and to spur productivity, profits, jobs, and income.

C.1.4. COMPETITION

Theoretical models of lending and industrial organization predict that firms' access to credit depends critically on bank market structure. The *market power* view argues that concentrated and uncompetitive banking markets are associated with less credit availability and higher price of credit, while the *information* view argues that competitive banking markets can lower credit by reducing banks' incentive to invest in acquiring soft information, a key ingredient in relationship lending. Recently, a number of papers have questioned this second view, highlighting that relationship lending is

FOSTERING SME LENDING THROUGH SUPPLY CHAIN FINANCE: NACIONAL FINANCIERA (NAFIN), MEXICO

NAFIN is a development bank in Mexico that offers on-line factoring services to SME suppliers. In 2001 Nafin developed a “Productive Chains” program that works by leveraging the links between large corporate buyers and small suppliers. The program allows small suppliers to use their receivables from big buyers to receive working capital financing, effectively transferring suppliers’ credit risk to their high-quality customers to access more and cheaper financing.

Two types of supply chain finance are offered: (i) Factoring offered to SMEs without any recourse, collateral, or service fees, at variable risk-adjusted rates; and (ii) Contract Financing, which provides financing up to 50 percent of confirmed contract orders from big buyers with NAFIN supply chains, with no fees or collateral, and a fixed rate. Financial training and technical assistance are also offered under the program.

As of mid-2009, the program comprised 455 big buyers (about 51 percent in the private sector) and more than 80,000 SMEs, and had extended over USD 60 billion in financing. About 20 domestic lenders participate in the program, including banks and independent finance companies.

Source: G-20 Stocktaking Report, 2010

only one type of technology that banks can use in lending to SMEs.²² Furthermore, a number of recent empirical papers have found evidence consistent with the market power view when it comes to the impact of competition on bank lending to SMEs.²³

The issue of competition and credit availability matters to SMEs in particular, because they are more limited in terms of the sources of finance available to them. Unlike large corporations, SMEs typically do not have access to the capital markets or to foreign sources of finance.

While in the case of other product and services, competition is seen as unquestionably beneficial, when it comes to the financial sector, there can be a trade-off between competition and stability, and an appropriate balance must be struck.²⁴ A sound regulatory framework is important to minimize these risks.²⁵ For example, capital requirements and provision

requirements can slow the growth of lending that might be motivated by competition, while competition may generate incentives for excessive lending. A positive balance can be promoted by imposing disclosure and information requirements, along with predatory lending regulation that places the burden of avoiding bad loans on the lender.

To increase financial access, leaders in this field have recognized that “policy should encourage competitive provision of financial services to customers such as low- and middle-income households and small firms. Policy should favour entry of qualified suppliers that are likely to improve the quality and price of services to such customers (in a manner consistent with financial stability and consumer protection). Competition policy should empower the active investigation of anticompetitive behavior.”²⁶ Effective competition requires clients to have both the information and the

22 See Berger and Udell (2006), Beck, Demirguc-Kunt, and Martinez Peria (2010), De la Torre, Martinez Peria and Schmukler (2009).

23 Carbo-Valverde, Rodriguez-Fernandez, and Udell (2009), Mercieca, Schaeck, Wolfe (2009).

24 Vives (2010) available at: <http://www.voxeu.org/index.php?q=node/5534>

25 Beck et al, 2011. A number of recent papers have questioned the negative implications of competition for stability. See Koskela and Stenbacka (2000), Beck, Demirguc-Kunt and Maksimovic (2004), Beck, Demirguc-Kunt, and Levine (2006), Cetorelli and Strahan (2006), Carletti, Hartmann, and Spagnolo (2007), Schaeck and Cihak (2008).

26 Claessens, Honohan and Rojas-Suarez (2009).

skills to compare rates and product attributes, one of the many reasons that developing financial capability is so critical. Examples of the positive effects of competition include better terms for borrowers, e.g., reduced interest rates and expanded services. Examples of the negative effects of competition in poorly regulated and supervised financial markets abound.²⁷

Standards, Best Practices, and Examples

An effective legal and regulatory framework will support a competitive environment by avoiding overly restrictive licensing requirements and allowing international and regional banks with better SME lending technologies and downscaling capacity to enter the market. It will also enable the growth of institutions that have proved profitable, such as mutual banks, and promote the development of alternative lending technologies such as leasing and factoring. Finally, an

effective legal framework promotes the development of securities markets and institutional investors as an alternative to bank lending for the largest firms, thus producing positive spill-over effects to SME lending.

Competition among financial sector players can be promoted further by introducing technological platforms in key areas, facilitating a variety of financial products and services, driving down the costs of financial access, and reaching previously untapped markets. A competitive marketplace for SME finance should include financial institutions as well as non-financial institutional providers with extensive business networks meeting appropriate criteria.

Of course, competition should not be introduced at the expense of prudential safeguards. Minimum capital requirements, adequate fit and proper tests, and other regulations would still apply. Moreover, banks in

EXAMPLE: BANKING SECTOR COMPETITION AND ACCESS TO FINANCE IN THE MIDDLE EAST AND NORTH AFRICA (MENA)

World Bank research suggests that the banking sector in the MENA region has a relatively low level of competition, due to a poor credit information environment combined with strict regulations and practices governing bank entry. Thus, measures to promote competition in MENA should focus on creating a more contestable market for banking and on improving the scope, access, and quality of credit information among banks. In addition, the promotion of stock markets and other non-bank financial intermediaries could help to promote a more competitive banking sector.

Improving competition in the MENA region may require a package of reforms, including relaxing licensing requirements and procedures without sacrificing the quality of entrants, improving financial infrastructure, and developing alternatives to bank lending. For example, more effective credit information systems would level the playing field between large and small banks (including new foreign banks) and allow these banks to expand more rapidly. Likewise, the existence of leasing and factoring providing alternative finance to SMEs, and institutional investors (mutual funds, insurance companies) providing the investor base for corporate issues, would increase competitive pressures on all segments of credit markets.²⁸

The high loan concentration in MENA also reflects many cases of long-established connections between large banks (including state banks and family-controlled private banks) and industrial groups. Such lending frequently entails large exposures and connected lending that may not have been well-regulated and supervised. Therefore, a stricter approach to regulation and supervision of large exposures and connected lending would need to be included in a package designed to reduce loan concentration and improve competition.

27 G20 Financial Inclusion Experts Group—ATISG Report.

28 Rocha et al, "Financial Access and Stability: A Roadmap for the Middle East and North Africa", 2011, World Bank

BEST PRACTICE: COHERENCE BETWEEN COMPETITION POLICY AND REGULATORY POLICY

Close collaboration is recommended between the regulator (in charge of financial stability and prudential regulation and supervision) and the competition authority (in charge of keeping the market competitive).

- •First, regulatory requirements and competition policy need to be coordinated.
- •Second, a protocol for cooperation between the regulator and the competition authority should be developed. This is particularly important in crises. The competition authority can commit to addressing too-big-to-fail problems that lead to competition distortions; the regulator can address the too-big-to-fail issue and moral hazard through systemic capital charges, effective resolution procedures, and restrictions on the scope of banking activities that target conflicts of interest.
- •Finally, crisis procedures should be established that define liquidity help from recapitalization and conditions for restructuring to avoid competitive distortions. Entities close to insolvency should be tightly regulated (and activities restricted) in a framework permitting prompt corrective action.”

Source: Vives (2010)

developing countries will also be subject to more stringent capital requirements (with greater reliance on core tier capital), leverage ratios, and other rules being proposed at the international level by the BCBS. This should not pose an immediate problem, as emerging country banks are generally better capitalized and less leveraged than banks in developed countries, but these banks will need to build up more capital in order to meet the growing needs of their economies, including the demand for credit by SMEs. Emerging country banks will also need to strengthen their risk governance in line with the more stringent standards being currently proposed by the BCBS.

Financial sector liberalization and banking regulations that allow the entry of sound and efficient banks (both foreign and domestic) and promote market competition may reduce margins and interest rate spreads. Such changes may also promote dynamism within the banking sector, as providers facing tough competition from new entrants seek new markets, and can further encourage local banks to look beyond traditional business lines, incentivizing them to develop SME banking. At a national level, openness to foreign banks may serve to increase access to capital, although it may also increase the risk of contagion from financial crises originating elsewhere, thus reinforcing the need for a sound regulatory

framework. The 1989 World Development Report provides a summary of sequencing strategies that should be followed in liberalizing financial sectors, in order to minimize the risk of instability.

Challenges and priorities for LDCs

In smaller and/or lower income countries, policymakers seeking to stimulate greater competition may only have access to a limited range of effective tools. Research on competition that targets developed countries suggests that a liberal entry policy vis-à-vis reputable financial service providers can help. Also of use are transparency of product pricing and the compulsory sharing of credit information, and rules about network access and interoperability of networks in the retail payments system. However, the latter may not be fully effective, since the applicability to developing countries of lessons learned in advanced economies is not straightforward.

C.2. Financial Infrastructure

Financial infrastructure as defined here includes accounting and auditing standards, credit reporting systems (credit registries and bureaus), collateral and insolvency regimes, and payments and settlement system. Financial infrastructure reduces the

information asymmetries and legal uncertainties that increase risk to lenders and constrain the supply of finance. Financial infrastructure development improves financial access for all firms, but SMEs benefit proportionately more, as the problems of opacity and information asymmetry are more severe in the case of smaller firms.

Establishing a solid financial infrastructure (auditing and accounting standards, credit registries/ bureaus, collateral, and insolvency regimes) should be a priority in the financial development agenda of most developing countries, as it can lower the costs and risks to financial institutions of serving SMEs, open the way for more modern and efficient lending techniques, and expand the proportion of SMEs that can viably be served. A sound financial information infrastructure should improve transparency and disclosure for SMEs in a cost-effective way, and help SMEs build a credit history, which is critical in helping to address both challenges of information asymmetry and cost to serve.

C.2.1. SECURED TRANSACTIONS

Creditor protection through modern secured lending legal regimes is associated with higher ratios of private sector credit to GDP.²⁹ Collateral and credit information are critical elements of a functioning credit system. The lack of these elements creates information asymmetry and a risk premium for borrowers who want to access credit. Moral hazard and adverse selection will be reduced if collateral frameworks are improved. Increasing the protection of creditors and debtor's rights and enforcement mechanisms can lead to a considerable increase in private sector credit to GDP and lowers NPLs.³⁰ Effective collateral regimes contribute to SME finance by reducing the risks and losses of lenders. As in the case of credit bureaus,

effective collateral regimes improve access to finance for all firms, but can prove particularly effective in improving access to SMEs. In countries with strong secured transactions regimes, asset-based lending technologies are facilitated.³¹

Typically, SMEs have limited immovable assets but possess a wider range of movable assets. An effective secured transactions regime facilitates lending by using the available movable assets as collateral in loan contracts. Firm-level data from around the world highlights the mismatch between the assets that firms hold and the assets that most banks accept as collateral.³² The value of movable property generally makes up *three-quarters* of firms' total asset portfolios and yet, on average, banks predominantly accept only land and buildings as their main form of collateral (Figure 2). Secured transactions laws and regulations, if formulated and implemented correctly, increase use of credit (via increased demand) by broadening the range of assets acceptable as collateral to banks to include both present and future assets (future crops or future receivables), tangible (equipment, vehicles, inventory, commodities, livestock, etc.) and intangible (accounts receivable, negotiable instruments, shares, intellectual property rights, etc.).

Standards, Guidelines, Good Practice

Modern principles of secured transactions systems have been established by the international community in the UNCITRAL Legislative Guide for Secured Transactions.³³ The recommendations of the Legislative Guide, as of this writing, constitute the most widely accepted international standards in this area.

To create a modern secured transactions system, in line with internationally accepted standards, the following elements and principles of secured transactions reform should be emphasized:³⁴

29 2005, Djankov et al

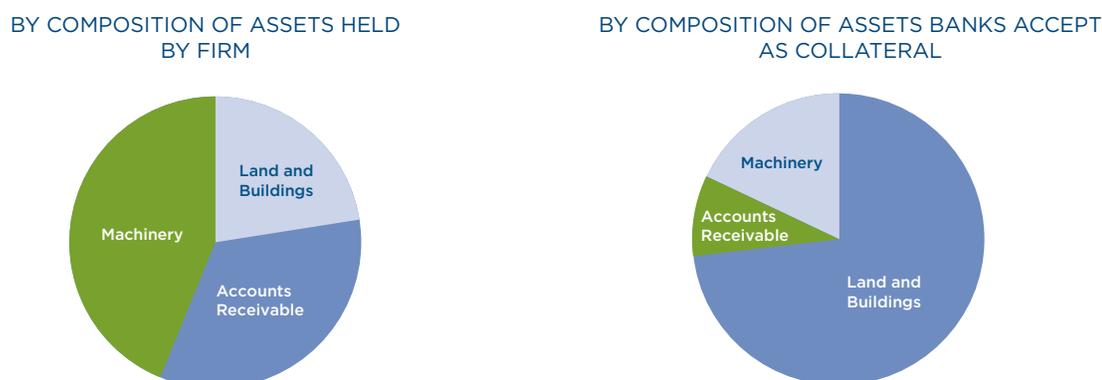
30 See "Private Credit in 129 Countries", Simeon Djankov, Caralee McLiesh and Andrei Schleifer, 2006.

31 Berger, Allen N., Gregory F. Udell. 2006. "A more complete conceptual framework for SME finance". World Bank. Available at http://siteresources.worldbank.org/INTFR/Resources/475459-1107891190953/661910-1108584820141/Financing_Framework_berger_udell.pdf

32 de la Campa, 2010

33 The World Bank Group has also endorsed the UNCITRAL international standards on secured transactions as reflected in both the "World Bank Principles and Guidelines for Insolvency and Creditor Rights Systems (revised 2005)" and the IFC Guide on "Secured Transactions and Collateral Registries" (2010)

34 Alvarez de la Campa, 2010

FIGURE 2 MISMATCH BETWEEN FIRM ASSETS AND COLLATERAL REQUIREMENTS:

Source: World Bank Group Enterprise Surveys, average from 60 countries.

- *Creating unitary legal systems vs. fragmented laws.* Creating or drafting a stand-alone law to regulate all aspects of security interests in movable property (secured transactions or personal property law) is considerably more efficient and creates less conflicts and uncertainty than revising existing provisions in multiple laws (commercial code, civil code, chattel mortgage law, etc.).
- *Establishing a broad scope of secured transactions law.* This can be accomplished by:
 - Allowing all types of assets (both tangible and intangible, present and future) to be used as collateral for loans;
 - Allowing broad pools of assets (revolving assets) with a generic description of the assets to be accepted as collateral to facilitate the use of credit revolving facilities;
 - Adopting the “functional approach” to secured transactions, which should allow equal treatment to all transactions secured by movable property no matter what their contractual nature (financial leases, consignments, assignment of receivables, secured sales contracts, loans secured with movable property, retention of title, etc.) with regard to publicity and priority vis a vis third parties; and
 - Allowing the automatic extension of the security interests to products and proceeds of the collateral to protect the value of the security interest.
- *Simplifying the creation of security interests in movable property.* This involves eliminating cumbersome and unnecessary formalities for the creation and enforceability of security interests in movable property.
- *Modernizing movable collateral registries.* The collateral registry is the cornerstone of a functioning and efficient secured transactions system. The registry fulfills an essential function of the system, which is to notify parties about the existence of a security interest in movable property (existing liens) and to establish the priority of creditors vis a vis third parties. Best practice elements of a modern collateral registry include:
 - Single data source (centralized) registry for all security interests, including non-consensual liens;
 - Web-based electronic system accessible 24/7;
 - Notice-based system, meaning that only information about the creditor, the debtor (who can be both a legal or natural person), the collateral, and the amount of the obligation/loan needs to be entered, without the need of any documentation sustaining that information;
 - Registrations to be done by creditors or their legal representatives directly into the system;
 - Information available to the general public for searches;
 - Search criteria that includes, at least, debtor identifier and serial numbered collateral;

- Flat and reasonable fees for registrations and searches;
- Registrar role limited to management, not to verify and modify information in the registry
- Non-cash payments (debit/credit cards, electronic transfers, or pre-paid accounts);
- Clearly defined liability of the registry for errors; and
- Secured and protected registry data, with established disaster recovery sites.
- *Establishing clear priority schemes for creditors.* A clear priority scheme is key to determine the sequence in which competing claims to the collateral will be satisfied when the debtor defaults on one or more of the claims.
- *Improving enforcement mechanisms.* Enforcement and collection of debts upon defaulted loans is a major impediment for increasing access to credit. Speedy, effective, and inexpensive enforcement mechanisms are essential to realizing security interests. Enforcement is most effective when parties can agree on rights and

remedies upon default, including seizure and sale of the collateral outside the judicial process.

A collateral regime designed to facilitate increased access to finance for SMEs is likely to include:

- A wide range of allowable collaterals (especially movable collateral);
- The establishment of clear priority schemes for creditors, clarifying the rights of secured creditors;
- Efficient collateral registries, making priority interests publicly known; and
- Effective enforcement of collateral in the case of default (both seizure and disposition).

Challenges and priorities for LDCs

The main challenges that LDCs face are: (i) lack of appropriate secured lending legal and regulatory frameworks; (ii) weak institutional capacity to manage a modern collateral registry system; (iii) limited knowledge on the importance of having solid secured

UNLEASHING THE POTENTIAL OF MOVABLE ASSETS AS COLLATERAL: THE CASES OF CHINA AND MEXICO

China - In 2005, China embarked upon a reform of its movable collateral framework to encourage financing against valuable movable assets. Before the reform, use of movable collateral, especially intangible collateral such as accounts receivable, under Chinese law was a key constraint for SME financing, as bank lending was largely based on real estate collateral, which SMEs typically do not possess. The reform model had three phases: development of the property law; creation of an electronic registry for accounts receivable and leases; and training of lenders to use movable assets as a basis for lending. Following China's reform of a movable collateral framework and establishment of the receivables registry, SMEs can now use a wider range of assets, such as receivables, as a basis for borrowing. In the three years (2008-2011) of operation of the new system, lenders have granted more than US\$ 1.5 trillion in loans secured with receivables to more than 100,000 businesses, more than half of them SMEs. The reform of the systems has also led to the development of the leasing and factoring industries, which have grown substantially over the same time period.

Mexico - Mexico has progressively introduced reforms in its secured transactions legal system over the past few years. But the reform that transformed the lending scenario for SMEs was the creation of a nationwide movable collateral registry in October 2010. With the new registry, the number of loans to businesses has increased by a factor of four, to around 23,000 in June of 2011. These 23,000 loans have generated more than US\$70 billion in financing to businesses, SMEs accounting for more than 90 percent of the firms receiving those loans. The reform has also led to a cumulative estimated saving for borrowers of US\$ 1.3 billion in registration fees associated to the registration of the security interest in the previous system. About half of the loans granted have gone to agri-businesses and farmers.

Source: G20 Stocktaking Report, 2010; de la Campa, 2010.

transactions and collateral regimes to promote access to credit; (iv) limited knowledge and/or appetite of financial institutions to offer movable assets based lending products; and (v) weak judicial systems, making enforcement of security interest an extremely challenging process.

Based on these challenges, these countries should emphasize the following in their priorities of intervention and reform approach:

- (i) Creating awareness among the public and private sectors about the importance of solid, secured transactions and collateral regimes;
- (ii) Development of simple laws and regulations based on best practice principles, taking into account the local context and sophistication of the financial sector;
- (iii) Development of modern registries that are sustainable and cost effective according to the local capacity to maintain the operations of the registry;
- (iv) Strong focus on capacity and training of stakeholders on the reform, along with user training that focuses on financial sector and business community);
- (v) Development of out-of-court enforcement mechanisms and capacity building programs for judges and enforcement officers on different enforcement mechanisms for security interests.

C.2.2. INSOLVENCY REGIMES

Bankruptcy regimes regulate the efficient exiting of the market, and make the resolution of multiple creditors' conflicting claims more orderly, resulting in more extensive opportunities for recovery by both the bankrupt entity and its creditors. Stronger creditor rights improve access to finance. Countries with stronger creditor rights tend to have a higher number of loan accounts per adult population and also higher rates of private credit to GDP.³⁵

Insolvency frameworks in many countries possess significant legal gaps that leave them poorly suited to

dealing with SMEs effectively. SMEs can be divided into two broad categories: corporates and non-corporates. Under most legal systems, corporates effectively limit the liability of shareholders to the amounts of their capital contributions to the business and, absent fraud or other mitigating circumstances, do not extend that liability to the ordinary debts of the business. Non-corporates, by contrast, do not possess a distinct legal identity from their shareholders and, as such, the debts of the business are the debts of the individual shareholders.

Although the trend in insolvency reform has been towards the creation of a single, unified insolvency act that deals with all legal forms, most countries have not undertaken such reforms. Most legal systems either have severely outdated insolvency law provisions or have modern insolvency frameworks contained in companies acts that either do not apply to non-corporates and or include outdated or nonexistent personal insolvency provisions.

Standards, Guidelines, Good Practice

A modern framework for SME insolvency will start with legislation for corporate SMEs that will include "fast-track" and expedited bankruptcy provisions in unified or corporate bankruptcy laws. Additional frameworks for dispute resolution, such as mediation, might also be included to help improve efficiency. For the vast majority that are non-corporate, however, this will involve entirely new legal frameworks for personal insolvency or updates to personal insolvency legislation. Legislation on personal/SME insolvency should provide for:

- A clear and transparent process by which entrepreneurs can seek to rescue their troubled businesses (including stays of proceedings and methods for making proposals to creditors for plans of arrangement);
- A clear method for liquidating the business should the business fail, repaying creditors in a timely manner, and discharging the remaining debts;

35 Djankov, McLiesh and Shleifer (2005)

- Clear protections for creditors, including lifetime limits on the number of times an individual entrepreneur can go bankrupt and punishments for fraudulent behavior; and
- Equilibrium between debtor and creditor protection.

The World Bank's *The Principles for Effective Insolvency and Creditor Rights Systems* (the *Principles*) are a distillation of international best practices regarding design aspects of these systems, emphasizing contextual, integrated solutions and the policy choices involved in developing those solutions.³⁶ Assessments using the *Principles* have been instrumental to the World Bank's developmental and operational work and in providing assistance to member countries. These assessments have

yielded a wealth of experience and enabled the World Bank to test the sufficiency of the *Principles* as a flexible benchmark in a wide range of country systems. The *Principles* address the following topics: legal framework for credit rights; risk management and corporate workout; legal framework for insolvency; and implementation of institutional and regulatory frameworks.

Challenges and priorities for LDCs

Creditor rights, measuring the strength of the collateral and insolvency regimes, are relatively strong in the OECD and in Eastern Europe and Central Asia (ECA), but weaker in other regions, especially in MENA, Africa, and South Asia. In these regions, policy

INSOLVENCY REGIMES FOR NON-CORPORATE ACTORS

For non-corporate SMEs, the absence of a personal or “merchant” insolvency framework leaves the SME exposed on at least three fronts:

1. SMEs that are fundamentally viable but find themselves in short-term liquidity crises have no safety valve for business distress. Where the legal framework is absent, the SME cannot seek temporary protection from its creditors, cannot propose a plan of reorganization, and cannot compromise debts in order to achieve greater returns to all creditors.
2. The absence of an efficient, orderly, and transparent liquidation process to repay creditors and return productive assets into the economy as quickly as possible also leaves SMEs vulnerable.
3. Where the legal framework is absent, individual owners of SMEs cannot obtain discharge from the SMEs' debt. When an SME fails, its outstanding obligations will be the obligations of the individual entrepreneur, in perpetuity, unless specifically forgiven by creditors.

The absence of these effective exit mechanisms inhibits entrepreneurship, limits the entry of SMEs into the market, and imperils the ability of creditors to be repaid. Not only are productive SME assets locked in a legal limbo for a longer period of time, delaying creditor repayment, but the absence of a debt discharge effectively inhibits the entrepreneur from re-entering the marketplace. Studies have tested the hypothesis that personal bankruptcy regimes stimulate entrepreneurship. They demonstrate that bankruptcy laws have the most statistically and economically significant effect on levels of self-employment across countries, and that more forgiving bankruptcy systems increase the supply of entrepreneurs. Four dimensions are considered in assessing how forgiving a bankruptcy regime is:

- (i) Availability of discharge (the release of outstanding debts owed by the debtor after liquidation of available assets) and time to discharge;
- (ii) Exemptions;
- (iii) Restrictions on debtor's rights during bankruptcy; and
- (iv) Difficulty in reaching an agreement with creditors.

Source: Uttamchandani, Menezes (2010)

³⁶ For more details, please see: http://www.wds.worldbank.org/external/default/WDSContentServer/WDSP/IB/2009/04/20/00033495_20090420051400/Rendered/PDF/481660WPOFINAL10Box338887B01PUBLIC1.pdf (as seen on May 17, 2011)

interventions that strengthen the financial information infrastructure have the potential to expand SME financial access by reducing information asymmetries between SMEs and financial institutions and by facilitating the use of various lending technologies.

In most LDCs, the vast majority of insolvency cases will result in the liquidation of the troubled enterprise, due in part to the relatively low value of SMEs in LDCs, which in turn reduces the incentive to restructure failing businesses. The prevalence of liquidation necessitates that one of the first orders of business in LDCs is the development of clear, predictable rules and processes to be followed when a debtor cannot repay its creditors, in order to foster greater confidence amongst potential lenders. These rules should address, *inter alia*, the financial conditions under which an insolvency process will be started with respect to a borrower, the process for liquidating assets to repay creditors, the role that creditors play in the liquidation process and in controlling the overall insolvency process, and the order of priority for distributing proceeds.

A built-in constraint to the improvement of insolvency processes in LDCs can be weak court capacity. Since insolvency cases often require urgent treatment by the courts, the ability of courts in LDCs to hear cases quickly and render decisions based on commercial analysis and predictable legal principles will serve as a hard constraint to the overall improvement of the insolvency system. As such, tackling the issue of court competency, particularly as regards the ability of judges to deal with commercial issues in a practical and timely manner, is critical. At the same time, finding ways to reduce the dependence upon courts for the resolution of insolvency cases will likely increase both recoveries by creditors and the number of distressed businesses that are able to successfully reorganize and continue as going concerns. In these regions, policy interventions that strengthen the financial information infrastructure

EXAMPLE: INSOLVENCY REGIME (COLOMBIA)

In 1999, as Colombia was in the midst of a financial crisis and facing a backlog of failing businesses entering a very inefficient bankruptcy process, the country undertook a reform of its bankruptcy code. This law, known as Law 550, streamlined the reorganization process by establishing shorter statutory deadlines for reorganization plans, reducing opportunities for appeal by debtors, and requiring mandatory liquidation in cases of failed negotiations. The pre-reform reorganization process was so inefficient that it failed to separate economically viable firms from inefficient ones. Once it was reformed, the country's insolvency system managed to separate viable from nonviable enterprises, allowing the former to restructure and liquidating the latter. By substantially lowering reorganization costs, the reform improved the selection of viable firms into reorganization, and increased the efficiency of the bankruptcy system.

Source: Giné and Love (2006)³⁷

have the potential to expand SME financial access by reducing information asymmetries between SMEs and financial institutions and by facilitating the use of various lending technologies.

C.2.3: CREDIT INFORMATION SYSTEMS

Credit reporting systems help satisfy lenders' need for accurate, credible information that reduces the risk of lending and the cost of loan losses by providing a reliable indication of whether an applicant will repay a loan. Research indicates that bank lending is higher and credit risk is lower in countries where lenders share information, regardless of the private or public nature of the information-sharing mechanism. Well-functioning credit reporting systems reduce adverse selection and moral hazard, and can contribute to both an expansion of credit and a reduction in lending costs by facilitating the adoption of lending technologies based on credit scoring models. The development of

³⁷ For further information, see Giné, Xavier and Love, Inessa, Do Reorganization Costs Matter for Efficiency? Evidence from a Bankruptcy Reform in Colombia (2006). World Bank Policy Research Working Paper No. 3970; available at http://siteresources.worldbank.org/DEC/Resources/Do_Reorganization_Costs_Matter_for_Efficiency-8Jul09.pdf

credit registries and bureaus is particularly important for smaller firms, given the more severe problems of information opacity and asymmetry in these cases.

Credit reporting systems comprise Public Credit Registries (PCRs) and Private Credit Bureaus (PCBs), and play two key functions in a financial system: they support banking supervision, and they promote access to finance by reducing risks for lenders. Supervisors make use of credit reporting systems to predict bank portfolio performance. Lenders make use of credit reporting systems to screen potential borrowers and monitor their performance. In the absence of solid credit information, lenders adopt defensive positions, requiring substantial collateral, increasing interest rates, or rationing credit altogether, thereby hindering the growth of segments like SMEs.

Assessing borrower creditworthiness is a major part of the cost of assessing a loan, therefore an effective credit reporting system can also reduce a lender's operating costs substantially. These cost savings dramatically reduce the size at which a loan becomes profitable, thereby improving access to credit for small borrowers. Credit reporting systems may also facilitate non-collateralized lending by providing sufficient information about a borrower's credit repayment history to offset, or reduce, the need for physical collateral. PCBs that incorporate "positive" credit history data have proven to be a valuable tool in the prevention of over-indebtedness. Without such information, lenders find it difficult to evaluate the total level of existing indebtedness that an individual or business has when they make an application for a new facility, often resulting in some individuals receiving too much credit that ultimately they cannot service – the 2002 credit card crunch in Korea is an excellent example of the dangers of rapid credit expansion without access to detailed credit history information³⁸.

A public credit registry is a repository of data collected by the central bank or other financial regulator

that incorporates information from banks and regulated financial institutions primarily for the purposes of offsite supervision. Over time, however, many PCRs have evolved into becoming information providers as well as supervisors by returning the collected data back to lenders in the form of basic credit reports. The provision of data to a PCR is almost always a mandatory requirement for regulated financial institutions. Such systems have the advantage of being able to compel banks to provide data that they may otherwise not wish to share. These systems are typically limited in scope and data coverage, and seldom collect information from outside the regulated banking sector.

A private credit bureau is an organization that collates data from a broad range of financial institutions (banks, non-bank financial institutions, utility companies, telecoms, etc.), then distributes it back to participating members through a common information-sharing mechanism (e.g., Experian, Equifax, Trans Union, CRIF, etc.). Lenders provide information about their clients to the credit bureau, including details of the loan and its repayment, on a voluntary reciprocal basis. These businesses also market a suite of value added products, such as credit scoring solutions, fraud prevention services, software applications, and consultancy services. PCBs, therefore, typically have a far greater coverage of the financially active market and provide a greater range of products and services than can be offered through a PCR. However, in some markets PCBs suffer from the voluntary nature of the data submission. For example, in emerging markets there is often considerable resistance from lenders to participate in PCBs on the grounds of competition and data security.

A third category of credit information service providers, **Commercial Credit Bureaus** (e.g., Dun and Bradstreet), cater to the needs of lenders, insurers, and business-to-business enterprises. Commercial credit bureaus fill a gap in the market that neither the PCRs nor PCBs have successfully serviced. The business

38 See Kang and Ma "Credit Card lending distress in Korea in 2003", available at <http://www.bis.org/publ/bppdf/bispap46k.pdf>

model is similar to that of the PCBs, but commercial credit bureaus also undertake more detailed investigative assessments of larger businesses. Like PCBs, they operate on a voluntary data submission basis but seldom seek reciprocity. The importance of this group of information service providers has been highlighted in recent times by the increasing demands of lenders for more information on SME businesses. A large number of SMEs have never borrowed from the formal banking sector and therefore have no track record in either the PCR or PCB, although small businesses borrowing in the name of the entrepreneur rather than in the business name can often be found in these databases. Many of these SMEs do, however, make regular use of trade credit, details of which can, typically, only be sourced through commercial credit bureaus. This history of trade credit is considered to be a key component in improving the risk assessment tools (scoring) for small businesses.

Credit Scoring is a statistical method of evaluating the probability of a prospective borrower to fulfill its financial obligations associated with a loan. The predictive value of credit scores is generally higher than that of assessments derived from credit histories alone, especially when applied to an identified and homogeneous group of borrowers or with regard to a specific product. Initially, credit scores were applied to individuals. However, the use of credit scoring techniques has come to be extended to other borrowers, including SMEs.

Standards, Guidelines, Good Practices

A key task is to consider measures ensuring that the credit reporting service providers collect sufficient, relevant, and usable data. Mandatory data collection and data access can help promote the rapid build-up of coverage and, with appropriate oversight, facilitate a more reliable database. Credit reporting systems are most effective when their data are electronically accessible, available in real time, and based on credit information that is current and easy to process. In a developing country context, where the information environment

SUCCESS FACTORS

A credit registry or bureau will be more effective to the extent that it:

- collects all relevant information, including both positive and negative information from regulated and non-regulated institutions (e.g., utilities, retailers);
- processes information in a safe and reliable manner keeping information accurate, updated, and complete;
- builds credit histories and other additional value added services for a large number of potential borrowers; and
- processes comprehensive credit reports in a timely and cost-effective manner.

In the G20 Stocktaking Report, success factors mentioned by credit bureau cases share similar trends, including:

- (i) an active exchange between the agencies that collect data and the suppliers to maintain an updated database;
- (ii) the use of non-traditional data sources to assess a company's credit risk; and
- (iii) increasing or recurring use of the database by the financial sector.

Source: G-20 Stocktaking Report, 2010

is particularly weak, there is a need to start collecting information from all relevant players inside and outside the financial services industry, including microfinance institutions, banks, non-bank financial institutions, utilities, and retailers. Credit bureaus should be encouraged to provide additional services, such as credit scores. Finally, credit reporting service providers should be able to effectively identify borrowers, which may necessitate inter-governmental cooperation in order to allow access to public record data.

The legal and regulatory framework should be clear, predictable, non-discriminatory, proportionate, and supportive of consumer rights. Regulatory measures should be flexible and dynamic enough to allow adjustments to changes in the credit reporting area. Some of the key elements that should be included in a credit

reporting legal and regulatory framework are: (i) clearly established scope of data and type of data contribution; (ii) inclusion of all relevant and available data (positive and negative data related to individuals and to businesses); (iii) participation of non-regulated entities; (iv) responsibilities and liabilities of each participant; (v) data that is detailed at the account level; (vi) historical data; (vii) consumers' rights, such as the right to object to their information being collected, the right to be informed, the right to access data, and the right to challenge data.

Credit scoring models may be applied to the analysis of credits to both individuals and businesses. When applied to individuals, personal information and the behavior of consumers are used. When applied to businesses, financial indicators are the variables used to determine the probability of insolvency. The basic approach for the development of a type of credit scoring model involves the following steps:

- **Planning and definitions:** markets and credit products for which a system will be developed; purposes for which the products will be used; types of custom-

GOOD PRACTICE EXAMPLES

Credit Bureau - Credit Bureau Singapore (Singapore)

The Credit Bureau Singapore was created in 2002 as the country's first commercial credit bureau, with the objective of helping lenders make faster and better-informed credit decisions. Credit Bureau Singapore (CBS), with support from the Government of Singapore, recognized at the beginning of the financial crisis that lending to SMEs was tightening and additional tools were needed to reduce information asymmetry. CBS is one of the few private credit bureaus in Southeast Asia that collates data with respect to both consumers and businesses. Through its association with Dun & Bradstreet, CBS has access to the trade credit data of thousands of Singaporean companies. In May 2010, CBS, in association with Fair Isaac Corporation, launched a custom credit scoring solution designed to accurately quantify the risk (probability of default) associated with SMEs' applications for credit. The algorithm behind the score incorporates credit history data from the business, including trade credit experience, and blends this with the personal credit history of the business owner and/or key stakeholders. This form of blended score is especially useful when assessing the risk profile of smaller businesses, where detailed financial information is either not available or often unreliable.

Companies Database - FIBEN Companies Database (France)

FIBEN is a corporate database set up in 1982 and managed by the Banque de France to facilitate the implementation of monetary policy and to verify the credit quality of bills issued for rediscounting. Credit institutions and public economic bodies have access to the FIBEN database, which contains data necessary for the analysis of credit risk (identity, legal event, management, indebtedness, financial appraisal by the Banque de France), serving as an important tool for analyzing risk, making decisions, and monitoring companies. Companies may also gain access to refinancing through the banking system, using private bills as collateral and supported by the central banks' payment systems operations. As of November 2009, the total amount of credit to SMEs in France was USD 262.4 billion. Credits granted by the banking sector to SMEs increased by over 1.9 percent between November 2008 and November 2009, whereas credits granted to the private sector in general decreased by 0.9 percent over the same period.

Credit Registry - Bank Negara (Malaysia)

Following the Asian financial crisis in 1997, Bank Negara (Malaysia) recognized the importance of sharing credit data as a means to improve the quality of lending decisions and prevent over-indebtedness. As such, the bank initiated the Central Credit Reference Information System (CCRIS) project, which today provides perhaps the most comprehensive repository of financial data in the region. The data set incorporates information on both individuals and companies, and is used by practically all lenders in Malaysia. The CCRIS database is among the best examples of a modern public registry, but while it adequately serves the needs of the retail sector, it has its limitations in the SME sector. Recognizing these weaknesses, Bank Negara is exploring ways to develop more SME-centric services in cooperation with the Credit Guarantee Corporation of Malaysia and the private sector.

ers; concept of nonperforming; horizon for forecasting model;

- Identification of potential variables: characterization of the credit proponent; characterization of the operation; selection of significant variables for the model; analysis of the restrictions to be considered in relation to the variables;
- Planning sample and data collection: selection and dimension of the sample; collection of data; assembly of the database;
- Determination of scoring formula through statistical techniques: for example, discriminant analysis or logistic regression; and
- Determination of the cut-off point from which the customer is classified as delinquent or good payer: the point from which the financial institution may approve the credit.

Some countries, such as India, have introduced **SME rating agencies** and/or specialist PCBs as additional institutions designed to generate and provide more information to prospective lenders. This is a relatively recent initiative that merits consideration by other countries. There are some critical issues that need to be revisited, such as the level of independence of the ratings provider (like those observed in the case of credit rating agencies). It is also possible that these agencies require a critical size of market to break even and become profitable. If this is the case, DFIs and governments could consider regional solutions, involving regional hubs that are large enough to dilute fixed costs, but that also contain expertise at the country level.

The World Bank's International Standards on Credit Reporting (see Annex III) provide an internationally accepted framework for credit reporting systems' policy and oversight. They are intended to serve as a guide for policymakers, regulators, banking supervisors, credit reporting data providers, credit reporting service providers, the users of the services, and individuals whose data is stored in these systems. The standards are based on the development of principles, guidelines, and roles for each participant in the system

EXAMPLE: SME RATING AGENCY OF INDIA (SMERA)

India's SMERA is the country's first rating agency focusing on the MSME sector, providing comprehensive ratings for the use of financial institutions in the assessment of credit. The government of India initiated the creation of SMERA in 2005, in coordination with other stakeholders, including 11 public and private financial institutions exposed to SMEs, in order to improve credit flow to the MSME sector. Diversified equity ownership by 11 banks enabled the lenders to accept SMERA's ratings and extend both financial and non-financial benefits to well-rated SMEs. SMERA ratings categorize MSMEs according to size, so that each MSME is evaluated among its peers. The pricing policy aims to keep fees affordable for SMEs. The rating fee does not exceed USD 1,155, for which the government provides a 75 percent rating fee subsidy. SMERA has completed over 6,500 ratings. The ratings have improved access to bank financing for at least 20 percent of rated clients, and collateral requirements have decreased in 10 percent of rated cases. A rating renewal in 20 percent of cases indicates usage of ratings for monetary benefit as well as a self-improvement tool. By the end of 2011, SMERA operations are expected to generate profits of 15 percent, and to have reached over 80,000 SMEs.

ensuring a comprehensive framework for the development of an efficient, safe, and reliable national credit reporting system.

Challenges and priorities for LDCs

In general, credit bureau coverage in developing regions is much lower than the average of the OECD. Credit bureau coverage in Sub-Saharan Africa and in South Asia is particularly weak. However, the existence of credit registries and bureaus seems to matter more in developing countries, suggesting a more important role for the government in promoting information-sharing in these countries.³⁹

While the challenges faced in LDCs are often similar to those of other markets, the barriers to sharing credit

39 Djankov, S., C. McLiesh, and A. Shleifer. 2007. "Private Credit in 129 Countries." *Journal of Financial Economics*, May 2007, available at: <http://ideas.repec.org/p/nbr/nberwo/11078.html>.

information tend to be more concentrated. In particular, LDCs tend to disproportionately suffer from the following market failures:

- *Weak Legislative environments:* The concept of sharing information about individuals and businesses incorporates a delicate balance between what is in the best interests of the financial system as a whole and the right to privacy of the data subjects, and to some extent the data providers (confidentiality). Typically, LDCs tend to have weak or nonexistent legislative regimes in the area of data privacy and, by default, tend to regulate in favor of confidentiality, an example being the banking secrecy provisions commonly found in central banking regulations. As such, these legislative frameworks actively prevent widespread sharing of useful data and provide legal “cover” for those institutions that see the sharing of such data as diminishing their competitive advantage. Specific regulations governing the operations of the credit information sharing environment or the removal of pre-existing constraints, such as amendments to banking regulations, can help alleviate these constraints.
- *Market concentration and anti-competitive behavior:* LDCs, and in particular smaller nations, tend to have a far greater concentration of suppliers than do more developed countries, often with one or two dominant lending providers. In these circumstances, the business case for sharing information is less obvious, and dominant suppliers view the sharing of information and the possible resulting loss of market share as a threat rather than an opportunity. In these environments it may be necessary for policymakers to take a more pro-active role and compel participation in such infrastructure (either public registries or private credit bureaus).
- *Size-related sustainability issues:* Smaller nations also suffer from the inherent cost dynamics of developing such infrastructure. While the cost of potential solutions can vary considerably, there remains a base level “entry cost” of technology and personnel to satisfy minimum data security and operational risk requirements. The size of the active credit market will subsequently determine the cost, or subsidy, of providing the service and its ultimate sustainability.

One method of overcoming these constraints is to consider the development of regional solutions that share common infrastructure. This, however, requires cross-border cooperation at the policy level, which adds an additional layer of complexity.

- *Institutional capacity constraints:* Credit information sharing mechanisms are undoubtedly a valuable tool in reducing information asymmetry, and thereby reducing the costs of loan losses and acquisition, but they are not in themselves a means of preventing such events. The tool is only as good as its operator, and the recent global financial crisis has demonstrated that the mere existence of these data sources may not prevent reckless lending practices. Many LDCs suffer from an inherent lack of skilled resources in the financial sector, which can lead to capacity constraints when it comes to adopting new tools and methodologies. The introduction of financial infrastructure, therefore, has to be seen in the context of a broader, more holistic, capacity development agenda.
- *Data quality and data matching constraints:* The quality of raw data at the institutional level is often incompatible with the needs of the information service providers. In this respect, there are various policy interventions that can have a profoundly beneficial impact on the development of the infrastructure. These could range from a very simple intervention from the central bank to compel all lenders to capture specific pieces of information, through making public record data available to the information service providers, such as the ID verification service, to more general national reforms, such as the enforcement of a common address format and the introduction postal (ZIP) codes at the address level.

C.2.4: PAYMENT SYSTEMS

Payment, clearance, and settlement systems are the means by which payments are made between system participants (mainly banks), within and across borders. A payment system represents a market infrastructure for the financial industry and is a basic foundation for the conduct of commerce without an exchange of physical cash or (increasingly) paper, such as checks.

Without a payment system that is sufficiently effective, efficient, stable, and competitively neutral to elicit confidence on the part of the banks that use it, modern modes of carrying out financial transactions would be impossible, or at least very costly.

Most SME businesses conduct business using cash. However, cash is subject to loss, theft, and destruction in a multitude of ways. Payment, clearance, and settlement systems that are effective, efficient, and stable encourage entrepreneurs to move into the formal economy and facilitate their relations with banks.

The infrastructure to support corporate payment and retail payments can also play a role in scaling up SME access to financial services and reduce the costs of doing business. Payment system service providers have developed a number of products to facilitate “corporate payments” in the entire value chain of doing business. SMEs rely on the retail payment infrastructure for their customers to discharge their obligations as well. Both segments are relatively less developed for SMEs than for larger corporations.

Standards, Guidelines, and Good Practices

A wide range of cost-effective payment instruments is essential for supporting economic development and customers’ needs in a market economy. The development of a country’s commercial, industrial, and financial sectors generally increases demand for greater diversity and use of non-cash retail payment instrument and services. Migrating cash-based payments to electronic payment mechanisms⁴⁰ like electronic funds transfers, card payments, and mobile payments would lead to important savings while expanding reach and increasing inclusion. Payment system reform initiatives would need to focus, therefore, on extending the availability and choice of efficient and secure non-cash payment instruments and services to consumer and businesses.

It is important that public authorities develop a coherent and holistic reform strategy. The World Bank is in the process of issuing Guidelines for Developing a Comprehensive Retail Payments Strategy. Such guidelines are based on clear public policy objectives that need to guide the policies and actions of national authorities in countries with under-developed retail payment systems. Key public policy objectives are: (i) safety and efficiency; (ii) affordability and ease of access to payment instruments and services; (iii) availability of an efficient infrastructure to process electronic payment instruments; and, (iv) availability of a socially optimal mix of payment instruments. These public policy goals should guide the actions of the public authorities, specifically the central bank, to positively impact the drivers of retail payment system development.

To implement such goals, regulatory authorities should consider using the following guidelines in designing their retail payments development agenda:

Guideline I: The market for retail payments should be transparent, have adequate protection of payers and payees interests, and be cost-effective.

Guideline II: Retail payments require certain underlying financial, communications, and other types of infrastructure; these infrastructures should be put in place to increase the efficiency of retail payments. These infrastructures include interbank electronic funds transfer systems, inter-bank card payment platforms, credit bureaus, data-sharing platforms, interbank real-time gross settlement systems, reliable communications infrastructure, and a national identification system for individuals.

Guideline III: Retail payments should be supported by a sound, predictable, non-discriminatory, and proportionate legal and regulatory framework.

⁴⁰ The adoption of the electronic payment mechanisms ranges from less than 1 transaction per capita in Africa, to more than 150 in high-income countries.

DEVELOPMENT INITIATIVES IN RETAIL PAYMENT INFRASTRUCTURE⁴¹

Automated and standardized payment transaction infrastructure: Electronic communication networks, such as those for various types of card payments and for telebank and internet payments, allow SMEs real-time initiation and authorization of retail payments. Common initiatives for developing these networks include:

- (i) Creation of standardized transaction processes for paper-based instruments;
- (ii) Introduction of electronic payment transaction networks that lower user costs; and
- (iii) Introduction of technologies and processes that digitize or electronically image paper instruments for electronic clearing and settlement.

Interoperability among transaction infrastructures: The interoperability or consolidation of transaction infrastructures can achieve scale and scope economies and reduce SME user cost with:

- (i) Adoption of common standards for instruments, communication, and transmission security for all networks to provide interoperable services;
- (ii) Facilitation of interconnectivity among proprietary network arrangements, notably ATM and electronic funds transfer at point of sale (EFTPOS) networks; and
- (iii) Adoption of common equipment (e.g., hardware and switch) and software standards to allow interoperability at point of sale (i.e., ATMs, card readers, internet connectors) among competing networks.

Interoperable and automated retail payment clearing and settlement infrastructures: Achieved through common interconnected information technology and often through actual centralization or consolidation of existing arrangements. Common initiatives for developing these infrastructure arrangements include:

- (i) Establishment of national or regionally interconnected automated clearinghouses to improve the speed and reliability of retail payments; and
- (ii) Interoperability or centralization of inter-branch and inter-bank clearing and settlement through regional and national centers.

Guideline IV: The retail payments industry should foster competitive market conditions, with an appropriate balance between cooperation and competition.

Guideline V: Retail payments system should be supported by appropriate governance and risk management practices.

Guideline VI: Public authorities should exercise effective oversight over the retail payments market and consider direct interventions where appropriate.

Standard setters and implementation agencies have provided a useful framework to guide reforms in

retail payment instruments and systems. In particular, the CPSS⁴² has identified a set of overall strategic goals and objectives for retail payment systems, based on the key public policy objectives of efficiency and reliability. In the specific context of countries with underdeveloped retail payment systems, a few additional public policy goals are necessary to provide a firm foundation for successful system development.

Challenges and priorities for LDCs

Preliminary results from the World Bank Global Payment Systems Survey show very large differences between higher-income and lower-income countries

41 CPSS, 2006

42 BIS, CPSS, "Policy Issues for Central Banks in Retail Payments", Basel, Switzerland, March 2003.

with regard to retail payment systems. While in most high-income countries any single individual performs on average 100 or more cashless transactions per year, this same indicator is less than 1 in many low-income countries. These disparities are attributed to the slow development of infrastructure and access channels for electronic payments in most developing countries; limited development of the internal payments system in corporates, banks, and financial service providers; and limited competition and an absence of specific strategies for addressing these issues.

According to World Bank experience, key constraints that inhibit the faster development of non-cash payments in developing economies include limited interoperability of the various sub-systems; limited competition and innovation in the banking industry, which typically results in higher costs and limited coverage of these services; limited financial access; and lack of knowledge and trust in the benefits attached to the use of electronic payment systems and instruments. As an example, only 10 percent of low-income countries surveyed in the context of the Global Payment Systems Survey have indicated that automated teller machines (ATMs) are fully interoperable, compared to 78 percent of high-income countries. Along the same lines, 25 percent of low-income countries perceive the cost of ATM withdrawals at another bank as high, against 15 percent of high-income countries. Such results, when seen in conjunction with ATM costs that are significantly higher per capita in higher-income countries than in lower-income countries, indicates an even lower level of utilization of the infrastructure in low-income countries.

Governments and regulators in LDCs need to play a proactive role in retail payment systems in terms of stimulating demand, catalyzing and co-coordinating action, and establishing appropriate regulation and oversight of retail payments system. In addition to safety and efficiency, at least three additional policy goals should be

considered by countries with particularly underdeveloped retail payment systems: i) affordability and ease of access to payment instruments and services; ii) availability of an efficient infrastructure to process electronic payment instruments; and iii) availability of a socially optimal mix of payment instruments.

C.2.5: EQUITY INVESTMENT

Most equity funding of SMEs around the world comes from two sources: retained earnings, and capital provided by savings, friends, family, groups of related companies, and other “angel” investors. Formal provision of equity capital is rare, due to principal/agent problems such as information asymmetry, adverse selection, and high monitoring costs. Essentially, most formal providers of equity capital do not achieve sufficient risk-adjusted returns to make the provision of additional capital worthwhile. Likewise, the costs of discriminating between attractive and other investments in young firms are high, relative to the size of the investments.⁴³

Two different sources of potential equity financing have been proposed to bridge the equity gap: i) private equity and venture capital vehicles (including equity funds and equity programs sponsored by government-sponsored development finance institutions); and ii) programs to raise equity in “development markets” on special stock exchange tiers. Each approach has a number of challenges, especially in low-income countries.

Venture Capital/Private Equity (VC/PE) organizations support the expansion and development of companies in their growing cycle, addressing some of the financing needs of high-growth firms that are not covered by traditional financiers. By intensively scrutinizing firms before providing capital (i.e., due diligence), then monitoring them afterward, VC/PE can alleviate information gaps and reduce capital constraints. This asset class contributes to reduce information asymmetries through improved monitoring and control,

43 Towards An Understanding Of Public Policy Measures To Encourage The Supply Of Private Equity And Venture Capital: Framework And Country Lessons, Clemente del Valle, Alex Lima, and Jorge Gomes, Unpublished paper February 2008.

relying on increased hands-on management of the portfolio companies compared to a bank lender. This allows companies with good growth prospects to secure risk capital financing that would otherwise be very difficult to obtain.

There are advantages for firms to have venture capital (VC) investors, such as the influence of professional and foreign board members on corporate governance, the establishment of oversight and audit committees (or provision of mentoring, for smaller SMEs), and the hiring of better CEOs. VC financing can foster innovation, patenting, and growth performances, and VC firms can professionalize their portfolio companies, connecting them with potential clients and suppliers, and attracting additional funding. However, this type of financing is only available (if at all) to companies with high growth potential where existing shareholders are willing to share ownership for the sake of increased growth and/or other non-financing benefits (e.g., access to knowledge, markets, etc.).

Equity funds are pooled investment vehicles that invest in unlisted equity, quasi-equity and, occasionally, debt securities. There has been an increase in participation in SME equity funds in emerging markets in recent years. Over the last decade, DFIs have expanded their participation in SME equity funds, and evidence suggests that there are close to 200 investment funds supporting small and growing businesses (SGB) in emerging markets.

Some countries have also created **SME stock exchanges** to facilitate access to public funds, although the performance of these exchanges has been mixed.⁴⁴ Over the years, many developed and developing countries have sought to address the issues faced by SMEs by establishing dedicated stock exchanges, junior market segments, or separate trading platforms exclusively for the SME sector, with the aim of facilitating access

to capital markets more quickly, with less stringent eligibility criteria, and at a lower all-in cost. However, the performance of many of these junior exchanges, particularly those in lower-income countries, has been unimpressive, with only a handful of SMEs electing to list on certain markets and with little or no new capital actually being raised. Notable middle-income and high-income country examples include the Alternative Investment Market (AIM) in London, the Growth Enterprises Market (GEM) in Hong Kong, KOSDAQ in Korea, MESDAQ in Malaysia, TSX in Canada, the MOTHERS market in Japan, and the Shenzhen SE in China.

Standards, Guidelines, and Good Practice

The government's role is to improve the environment for private equity funds and VC investors, such as removing tax penalties on VC capital gains and formalizing the private placement market, as an alternative exit strategy. In general, access to equity markets can be increased by improving corporate governance through a broad range of interventions:

- Improvements in minority shareholder protection, providing a more secure and attractive environment to investors. This requires the implementation of international standards in basic shareholder rights, reduced thresholds for shareholder actions, and increased liability for CEOs and directors.
- The creation of a stronger domestic institutional investor base and greater participation of foreign investors, which may require the relaxation of limits on foreign ownership of listed companies in some countries.
- Enhancing the role of the board of directors and clarifying their responsibilities, and introducing independent members of the board, sometimes through the creation of a code of good practice.
- For larger firms, improvements in disclosure – improved financial reporting, use of board audit committees comprising independent directors to oversee auditors, and improving non-financial

44 OECD (2006) provides a comprehensive review of equity finance in the early stages of the life cycle.

disclosures, to include management's discussion and analysis of financial results in the annual report and governance standards.

Private equity / venture capital

The expertise and profit-seeking instincts of professional fund managers are essential to the development of a sustainable private equity sector. Successful programs such as SBIC (US), ECF (UK), Yozma (Israel), IIF (Australia), and Inovar (Brazil) have had a lasting effect on the industry and on the innovative infrastructure of those countries.

Actions that could be taken include:

- Liberalizing investment restrictions on local institutional investors, allowing a VC/PE industry to tap into national savings in search of opportunities for diversification and improved returns. This is closely related to a balanced supervision of investment vehicles and fund managers by regulators.
- Establishing a conducive tax framework for entrepreneurs and institutional investors, designed to enable and stimulate entrepreneurship and the investment in productive risk taking activities, including the introduction of investment vehicles with tax pass-through capability and a differential fiscal treatment of the capital gains earned PE/VC firms, which acknowledges the high risk faced by investors.
- Reducing capital controls on the repatriation of long-term foreign capital gains and improving protection and rights of VC/PE investors' contributions in order to increased foreign investment. This includes regulation of minority investors' rights, and standards of disclosure and fund management.
- Liberalizing regulation. The professional nature of the investors in this asset class requires less protection from regulators, allowing for potentially higher returns. More flexibility should be provided in comparison to other asset management firms (e.g., mutual funds) that invest capital from the general public. This includes portfolio valuation and reporting requirements.
- Building professional expertise, a key to the development of the VC/PE industry. This is even more critical in developing countries, given the relative shortage

EXAMPLE: DEVELOPING PRIVATE EQUITY / VENTURE CAPITAL MARKETS

The Inovar Program in Brazil was designed in 2001 by Financiadora de Estudos e Projetos (FINEP), which provides funding to strengthen technological and scientific development in Brazil, in coordination with the Inter-American Development Bank. The objective of the program is to support the development of new, SME technology-based companies through the establishment of a venture capital (VC) market and to enhance private investment in technology businesses. Inovar created a research/knowledge and information dissemination platform and develops managerial capacity for channeling and accelerating VC investments in small-company funds in Brazil. The program successfully achieved the creation of a VC portal with information on how to register for different program components, with over 2,650 registered entrepreneurs, and over 200 investors. It also established a Technology Investment Facility where investors can perform joint analyses and due diligence on VC finds, which resulted in over 50 joint due diligences with approximately USD 165 million committed/approved in 15 VC funds. The program has also established 20 venture forums for SMEs to interact with potential investors and present business plans, resulting in 45 SMEs receiving over USD 1 billion in VC/PE investments.

Source: G-20 Stocktaking Report, p. 73

of such specialize resources. Potential policy options in this area include: promoting and funding education and training initiatives at national and international settings; encouraging the teaming of international general partners (e.g., Yozma program and some IFC funds); and allocating resources to funds managed by new managers.

- Indirect intervention through market-based approaches, which, given the experience in a number of countries, is preferred to direct equity investments on the part of government agencies.
- Calibration of incentives for risk sharing and return allocation, where the design of co-investment programs involves a combination of government and private sector financing. The preferred capital structure is one where the government as investor adopts a

THE BENEFITS OF AND EXPERIENCE WITH PRIVATE EQUITY FUNDS

The benefits of private equity funds can be assessed from different perspectives. At the macro level, private equity can catalyze structural changes through support to new economy sectors and foster industrial innovation.⁴⁵ It can help reduce unemployment rates, mainly for skilled workers,⁴⁶ and spur overall employment growth.⁴⁷ Industries with private equity investments grow faster in terms of production, value added, and employment, while at the same time exhibiting more resilience to industry shocks.

Employment and sales growth rates reported for random samples of exited deals in South Africa, Tunisia, and Morocco support the perception that private equity fund-backed businesses grow faster and create more jobs than those without private equity fund support. South African businesses that were backed by private equity funds grew their sales by 20 percent, outperforming Johannesburg Stock Exchange (JSE) listed companies and companies included in the All Share Index ALSI by 2 and 6 percent, respectively⁴⁸ (). Similarly, these private equity fund-backed companies reported employment growth rates significantly superior to regional rates estimated at 2.88 percent for North Africa and 2.98 percent for sub-Saharan Africa. The involvement of private equity funds in African businesses seems to foster innovation as well. For instance, 69 percent of private equity fund-backed companies introduced new products and/or services. The annual growth rate of R&D in private equity fund-backed businesses was 7 percent, seven times the rate reported for JSE listed companies over the same period⁴⁹.

“Financing Africa Through the Crisis and Beyond” Beck et al, 2011; Bernstein et al., 2010.

position akin to that of a limited partner. An arms-length relationship prevents government involvement in the management and asset allocation of the fund.

- In public/private investment programs, the adoption of asymmetric allocation of returns rewarding private investors beyond their share at the expense of government returns. This type of added incentive can provide a valuable incentive to private sector participation and has been used in the context of the investments by international development institutions, like the IFC.

Equity funds: In general, deal flow and exit opportunities in most of the smaller emerging countries are too limited to support dedicated single-country funds. Thus, successful SME fund models usually cover more than one country, with a small central team and local management teams in each country. This structure allows the local teams to focus on investments while spreading overhead costs over as

broad a base as possible. The central platform shortens the learning curve for the local teams and provides necessary services and support in an efficient and cost-effective way.

SME Stock exchanges: Setting up SME stock exchanges or junior markets can further improve the supply of equity investment to SMEs, although most are not considered successful. Establishing a trading platform and equipping it with modern systems and infrastructure is in itself no guarantee of success; improvements to the wider enabling environment for capital markets are necessary. The SME exchanges that have succeeded globally are those where: (i) the underlying legal and capital market regulatory frameworks are reasonably well-developed, robust and, above all, trusted by investors; (ii) access to credible corporate information on SMEs is widely and readily available; (iii) a reasonably broad spectrum of early-stage equity capital is available from angel, venture capital, and private

45 Kortum, S. and J. Lerner, 2000.

46 Rainer Fehn & Thomas Fuchs, 2003

47 Belke, A.; R. Fehn, and N. Foster, 2003

48 The Economic Impact of Venture Capital and Private Equity in South Africa, 2009 SAVCA/DBSA 2009

49 Ibid

equity investors; and (iv) the size of both the private sector and the qualified institutional investor community is sufficiently large to support the growth of the market generally.⁵⁰

Experience suggests that it is important to get the details of the market micro-structure right in order for an SME exchange to function effectively and become a venue where SMEs can readily access the capital they require. The following mitigate against success and should be avoided:

- Imposing expensive requirements such as maximum bid-ask spreads;
- Applying trading regulations that are more relevant for larger companies and do not provide incentives for market participants to get involved with smaller companies; and
- Failing to address relatively high issuance and trading costs caused by the introduction of systems and technologies developed for large-cap shares.

It is important to develop less formal, more lightly-regulated capital markets that can cater largely to SMEs. In Kenya, where there is an informal and largely unregulated capital market that caters mainly to SMEs, a number of small companies have been able to raise capital from local investors such as private equity firms. While aware of its existence, the securities market regulator in Kenya does not regulate the activity in this market, but at the same time appears reluctant to see it disappear altogether or close down.

A variety of other suggested policies have potential to increase listings and liquidity on SME exchanges, including:

- The size of qualified SMEs should not be capped at very low levels, as this may have adverse effects on liquidity and discourage the participation of fund managers;
- The public float should have a minimum size, as an excessively low float will also constrain liquidity. Some successful SME exchanges impose a minimum float of 10 percent, combined with commitments of

market-making and research by the broker;

- A large minimum number of shareholders may be necessary to improve liquidity;
- Lock-up periods of 6-12 months or longer during which certain shareholders (with 5 percent or more of the shares) cannot sell their stake following an IPO can prevent the early exit of corporate insiders and curtail insider trading; and
- Governments might consider tax incentives for SMEs that go public.

In addition to less formal markets such as those described above, another approach that may be more suitable for meeting the needs of SMEs in smaller economies is to promote the establishment of regional SME funds, or in some cases to encourage eligible SMEs to consider using other nearby or regional stock markets as a venue where they may be able to raise the funding they need. Particularly for SMEs located in smaller economies, regional approaches like these may be the most, if not the only, suitable way to access equity capital.

Priorities and challenges for LDCs

In developing economies, where the financial sector is typically characterized by marked weaknesses that constrain the access to finance, private equity can be a valuable source of stable, longer-term financing for some firms. This is particularly true in economies where public equity and bond markets are not accessible other than to a handful of companies, and where bank credit is expensive and provided primarily on a short-term basis, when available at all. The “smart-money” features of private equity investments and the selection of investment targets are particularly valuable for economies where business and management expertise constitute scarce commodities. This financing tool has a direct impact on the active management of the firm via the value created post-investment, which in turn has potential spill-over effects to the rest of the economy. It enhances value by fostering innovation and access to markets, building capacity at the management level in

50 Mako, 2010

areas such as marketing, management recruitment, strategic direction, increased contacts/network and financial advice. This can contribute to raise the general level of management standards and corporate governance in developing countries.

For the majority of SMEs in emerging markets, funding from private equity funds is not generally available, however. SME equity funds in emerging markets face particular challenges, including a shortage of experienced fund managers with the right skill set and market knowledge, and low capital needs of small businesses, making the deal sizes unattractive to most private equity firms. As noted above, the performance of SME stock exchanges in developing countries has generally not been good. Public or development finance to catalyze or provide equity-type financing for innovative and high-potential SMEs can be needed in the interim to address these market failures.

Government-backed funds can stimulate innovation and the adoption of innovations, compensating for a lack of available capital for innovation (for example, angel finance investors, venture capital funds). Many fund examples in the developing world are supported by donors or development finance investments, allowing them to serve difficult-to-reach clients. Key success factors of these equity fund cases include

having a skilled and experienced fund manager, and achieving the targeted financial return through the fund's investments.

The Jordan Enterprise Development Corporation is financing an innovation fund with the Government of Jordan, the European Investment Bank, and Abraaj Capital. The Oasis 500 early stage and seed investment network offers small amounts of start-up capital linked to intensive mentoring and business incubator support, while the \$500 million (target size) RED Growth Capital Fund set-up by Abraaj Capital is complemented by mentoring, networking, and informational support to high-potential and innovative growth SMEs.⁵¹ Further source of funding can be from Diaspora.

C.2.6: ACCOUNTING AND AUDITING STANDARDS FOR SMES

Strong accounting and auditing standards improve SME access to finance by reducing informational opacities and encouraging lending based on financial statements, but countries have had to strike a balance between improving transparency and reducing the regulatory burden for SMEs. Reporting and audit requirements for SMEs, whether regulatory or simply required by banks as a consideration for accessing credit, can improve the

The Korea Venture Capital Investment Corp (KVIC)

KVIC is a government-backed fund of funds established in 2005 to provide stable capital to SMEs in innovative technology sectors. KVIC currently has USD 1.5 billion in assets under management in over 150 venture capital and buyout firms, and commits USD 200-300 million every year to venture capital funds. The KVIC also supports partnerships funds to invite foreign investors into the funds, promoting global networks and ensuring transparent fund management systems. The establishment of KVIC led to creation and strengthening of Korean legislation to provide stable capital to the venture capital industry, and also influenced the amending of regulation to attract more private investors into venture capital funds. Such funds have the potential for significant positive financial and developmental impact, including increased employment, skills development, corporate governance best practices, and innovation.

KVIC targets specialized SMEs in the relatively riskier segments of high-growth technology and innovation, reflecting their more mature SME equity markets and lower information asymmetries relative to developing countries where equity funds have recently begun to develop, and thus cater to the overall SME segment.

51 Pearce, 2011

quality of SME information, but can also act as a barrier to SME finance and growth. External audits can be costly and difficult to justify, as SME accounting is usually straightforward, relying on historical cost-based, rather than fair value, measurement. They may also act as an incentive to stay disengaged from the formal sector and full regulatory compliance.⁵²

International Financial Reporting Standards (IFRS) have been adapted and streamlined for SMEs, and about 60 countries have adopted the SME version of IFRS. However some countries have concluded that the SME version of IFRS is still too costly and burdensome for local and smaller SMEs, and have adopted a simpler set of obligatory standards. There are similar concerns regarding obligatory auditing. Although auditing improves the reliability of financial statements, the EU exempts firms with fewer than 50 employees from obligatory audits, a rule that also attempts to strike a balance between the objectives of improving transparency and reducing the regulatory burden for small firms. Some studies have found that effective accounting standards are positively associated with measures of access, but research in this area has been limited by the lack of good quantitative indicators of the quality of financial reporting, and are not focused on SMEs.

There has been substantial debate around developing accounting and auditing standards for SMEs that strike the right balance between transparency and regulatory simplicity. SMEs are typically non-public entities with simple financial transactions. Many of the disclosures aimed at public shareholders and lenders may be unnecessary for SMEs. Several countries resist adopting IFRS for SMEs, claiming that these standards remain excessively complex and costly for smaller firms.

World Bank research shows that many countries use company size to determine a company's financial reporting and audit requirements, although the relief that is given tends to be quite limited. Most commonly, SMEs are exempted from statutory audit

GLOBAL TECHNOLOGY AND INNOVATION PARTNERS (GTIP)

Diaspora can play a prominent role in introducing and financing innovation, as has been widely acknowledged in the case of India and Israel. An emerging example is the Arab Diaspora links to support SME Innovation in the MENA region. Global Technology and Innovation Partners (GTIP) is a partnership of successful Arab diaspora entrepreneurs based in Silicon Valley, targeting investments across the Middle East, North Africa and South Asia regions (MENASA). GTIP has recently established the "Rising Tide Venture Capital Fund" (\$250 million being raised) that will focus on building local entrepreneurial ecosystems and provide seed, early, and growth-stage capital for innovative ventures in MENASA countries. To help ensure the development and acceleration of successful and innovative start-ups in the region, GTIP intends to pool their staff, partners, and other successful entrepreneurs from Silicon Valley, and elsewhere in the United States to provide companies in MENA with continuous mentorship and expertise.

GTIP has two key partners to help transfer support and provide mentorship: Plug and Play Technology Center (PnP), which is a technology incubator based in Silicon Valley, and the TechWadi networking association, which allows GTIP to tap into the Arab diaspora to provide mentorship and advice to MENA entrepreneurs.

requirements and/or are subjected to simplified accounting standards. However, the thresholds used to define SMEs are often quite low and exempt only the smallest of companies. There is significant resistance, often motivated by genuine concerns, within parts of the accounting and audit profession to the notion that SMEs should be afforded greater relief in their financial reporting and audit obligations. The benefits of differentiated standards or systems need to be better understood.

Standards, Guidelines and Good Practice

A clear case can be made in favor of simplified accounting and financial reporting framework for smaller

52 Ibid

IFRS FOR SMES

The IFRS for SMEs is a self-contained standard of 230 pages, designed to meet the needs and capabilities of SMEs. Compared with full IFRSs (and many national Generally Accepted Accounting Principles), the IFRS for SMEs is less complex in a number of ways:

- Topics not relevant for SMEs are omitted. Examples: earnings per share, interim financial reporting, and segment reporting.
- Where full IFRSs allow accounting policy choices, the IFRS for SMEs allows only the easier option. Examples: no option to revalue property, equipment, or intangibles; a cost-depreciation model for investment property unless fair value is readily available without undue cost or effort; no “corridor approach” for actuarial gains and losses.
- Many principles for recognizing and measuring assets, liabilities, income, and expenses in full IFRSs are simplified. For example, amortize goodwill; expense all borrowing and R&D costs; cost model for associates and jointly-controlled entities; no available-for-sale or held-to-maturity classes of financial assets.
- Significantly fewer disclosures are required (roughly 300 versus 3,000).
- The standard has been written in clear, easily translatable language.
- To further reduce the burden for SMEs, revisions to the IFRS will be limited to once every three years.

Source: <http://www.ifrs.org/IFRS+for+SMEs/IFRS+for+SMEs.htm>

enterprises, with requirements commensurate with their size, the types of transactions they conduct, and their limited range of stakeholders. A “one-size-fits-all” approach to financial reporting and auditing requirements ignores the capacity constraints that SMEs face and unnecessarily increases the cost of doing business for those enterprises, which generally drive economic growth. In addition, by increasing the requirements for SMEs, governments may create disincentives for businesses to operate in the formal sector. A holistic approach would take into account SMEs’ need for relief from excessive accounting and auditing requirements, as well as their need for more time to implement appropriate standards effectively.

Recognizing this, the International Accounting Standards Board (IASB) issued in 2009 a simplified version of its full IFRS, as many SMEs argued that full the IFRS imposed a burden on them, a burden that had been growing as IFRS became more detailed and more countries had begun to use it.

Prior to the issuance of IFRS for SMEs, the United Nations Conference for Trade and Development’s Intergovernmental Working Group of Experts on International Standards of Accounting and Reporting (UNCTAD-ISAR) had already developed a three-tiered system for financial reporting, as follows:

Level 1. This level would apply to listed enterprises whose securities are publicly traded and those in which there is significant public interest. These enterprises should be required to apply the IFRS issued by the IASB.

Level 2. This level would apply to significant business enterprises that do not issue public securities and in which there is no significant public interest. This set of standards is likely to be superseded by IFRS for SMEs.

Level 3. This level would apply to smaller enterprises that are often owner-managed and have no

TABLE 2 FINANCIAL REPORTING AND AUDIT RELIEF GIVEN TO SMES

Country	Preparing F/S	Accounting standards	Statutory audit	Publication
Albania		✓	✓	
Brazil	✓		✓	✓
China	✓	✓		
Croatia	✓	✓		n/a
Egypt	✓			n/a
El Salvador		✓		n/a
Indonesia			✓	
Morocco	✓		✓	n/a
Pakistan		✓		n/a
Panama		✓	✓	n/a
Sri Lanka		✓		n/a
Thailand			✓	
Tunisia			✓	n/a
Vietnam		✓	✓	

✓ Lesser requirements for SMEs (size criteria)

n/a Not required of any non-listed company, regardless of size or legal form.

Source: Financial Reporting and Audit Requirements of Small and Medium-Sized Enterprises

or few employees. The approach proposed is simplified accruals-based accounting, closely linked to cash transactions. National regulators may permit a derogation for newly formed businesses or new entrants to the formal economy to use cash accounting for a limited time. IFRS for SMEs is likely to be overly complex for these enterprises.

This three-tiered approach is broadly in line with the recommendations made by the World Bank though the

Reports on the Observance of Standards and Code-Accounting and Auditing (ROSC A&A) assessments. It has already been put in place in several countries, including the signatories of the OHADA (Organisation pour l'Harmonisation en Afrique du Droit des Affaires) Treaty in Francophone Africa.⁵³

Challenges and priorities for LDCs

As outlined, many LDC accounting professions may currently be too weak to effectively support even IFRS

53 See ROSC A&A for Senegal (available in French), at: http://www.worldbank.org/ifa/rosc_aa_sen_fre.pdf

for SMEs. Capacity building and development is needed, including for oversight institutions.

While the IFRS for SMEs are less burdensome than the full IFRS, they may still be excessive for smaller and capacity-constrained enterprises. Exemptions from IFRS and other requirements for smaller firms may be merited, or the development and implementation of simplified versions.

C.3 Public Sector Interventions

Many governments seek to encourage SME finance through direct and indirect interventions, in order to address deficiencies in the enabling environment and residual market failures. Well-designed policy interventions can be useful as transitional measures in periods where the government is trying to strengthen financial infrastructure and the legal and regulatory framework. They may also be valid in cases where some groups remain difficult to reach, even when efficient financial infrastructure and regulations are in place. Interventions can also be important in periods of instability and crisis, where there is an actual or potential collapse of financial intermediation by private agents.

The worldwide financial crisis dented confidence in the belief that reliance could be placed solely on market solutions for access to financial services, and has triggered a range of public initiatives designed to protect or re-launch the flow of credit to various purposes and sectors.⁵⁴ Government policy interventions have included partial credit guarantee schemes, direct lending facilities (sometimes entailing credit subsidies), and lending by state-owned financial institutions. These interventions provide different combinations of liquidity and risk mitigation strategies and can be priced at or below market rates. The choice of instrument/intervention typically depends on the binding constraint in the respective environment. The

government support initiatives with the greatest representation in the G-20 stocktaking exercise include: funded financing facilities extended via state banks and/or private financial institutions; credit guarantees extended via state banks and/or private financial institutions; and, state bank initiatives.

Government support mechanisms can expand significantly the SME finance space, although it is always important in these cases to minimize their potential market distorting consequences, and to not lose sight of the fact that financial services for SMEs are best served by strong banking and non-banking institutions that can develop business models to achieve the optimal balance between risk, reward, and cost. The more supportive the overall enabling environment is in a given country, the larger the size of the bankable SME space, which provides incentives for financial players to engage in this space and increases odds of success and demonstration effects.

The following table estimates the amount of financing per SME in examples of public sector interventions that are profiled in this section. While this is a rather superficial and incomplete assessment, and the ratios are influenced by the age of the interventions (the Turkey and Korea models are more recent, for example, and may still be growing), this is still useful in providing insights regarding the cost-effectiveness of each example. The three partial credit guarantee facilities come out relatively well on this measure.

As is clear from the 2010 GPFPI stocktaking exercise, government-supported interventions in the SME finance space are commonplace. The “perfect” enabling environment for finance being a long term/tentative objective, government support is always likely to be needed to provide incentives, catalyze a market, or create a demonstration effect, if not for purely political reasons. In all cases, government intervention (state banks, lending facilities, credit guarantees, risk-sharing,

54 Center for Global Development. 2009. “Policy Principles for Expanding Financial Access.” Report of the CGD Task Force on Access to Financial Services. Washington DC.

TABLE 3. FINANCING PER SME: COMPARISON TABLE

Country	Name of Program	Starting year	Financing Amount (USD m)	Number of SMEs outreached	Financing per SME (USD)
Afghanistan	DEG - SME Credit-Guarantee-Facility	2005	37	1,256	29,459
Brazil	Programa INOVAR I-II	2001	1,000	3,250	307,692
Canada	Business Development Bank of Canada	1944	15,008	28,000	536,000
Canada	Canada Small Business Financing Program	1999	8,000	113,850	70,268
Chile	FOGAPE (SME lending guarantee fund)	1980	9,636	362,753	26,564
EU	EU/EBRD SME Finance Facility	1999	3,168	101,000	31,366
Korea	The Korea Venture Capital Investment Corp	2005	1,100	930	1,182,796
Turkey	European Investment Bank SME APEX Facility	2005	216	343	629,738
WB&G	European-Palestinian Credit Guarantee Fund	2005	43.2	1,200	36,000

Source: Scaling-up SME access to financial services in the developing world, 2010

capacity-building, etc.) should be carefully designed and better evaluated with a view to accurately measure their achievements in terms of outreach, additionality, and leverage. Subsidies should be only reserved to address actual market failures, and carefully designed to avoid any disincentive for private sector providers of financial services to serve the SME segment.

Public procurement also represents a huge opportunity for SMEs, and can be used to improve SME access to financial services, including supply chain finance. The value of public contracts awarded to SMEs in a number of European countries during the recent global

financial sector crisis was much larger than the value of guarantees provided to SMEs.

C.3.1: STATE BANKS

State-owned banks have played an important role in SME finance in many developed and emerging countries as shown by two World Bank surveys, one conducted globally and the other focused on the MENA region.⁵⁵ Both surveys show that the share of SME loans in total loans is not significantly related to bank ownership, even after controlling for other factors. The survey conducted for the MENA region shows that

55 Beck, Demirgüç-Kunt, and Martínez Peria. 2008. "Bank Financing for SMEs around the World: Drivers, Obstacles, Business Models, and Lending Practices." World Bank Policy Research Working Paper 4785. The World Bank, Washington DC. Rocha, Farazi, Khouri, and Pearce. 2011. "Bank Financing for SMEs in the MENA Region: Evidence from a Joint Survey of the World Bank and the Union of Arab Banks." Policy Research Working Paper 5607. March. The World Bank, Washington, DC.

state-owned banks take more risks in SME lending relative to their private counterparts – they are less selective in their strategies to target SMEs, have a lower ratio of collateralized loans to SMEs, and have a higher share of investment lending in total SME lending. The same MENA survey shows that state banks have less developed SME lending technologies and risk management systems relative to private banks – a lower share of state banks has dedicated SME units, makes use of credit scoring, and conducts stress tests. In other words, state-owned banks seem to make a positive contribution to SME finance and are willing to take more risks to perform their mandates, but do not seem to have the capacity to manage these risks effectively.⁵⁶

These results are consistent with other empirical research showing that the financial performance of state banks is generally weak by comparison with that of private banks. State-owned banks can have lower levels of profitability due to lower margins, larger overhead costs due to excessive personnel, and higher levels of non-performing loans. This is to the result of a combination of factors, including development mandates that frequently entail larger exposure to risk, systematic political interference leading to poor lending and employment decisions, and internal operational deficiencies. All in all, the empirical literature suggests that the record of state banks as policy intervention tools is mixed, and their contribution to access to finance frequently comes with a cost.⁵⁷

At the same time, some countries seem to have been able to introduce reasonable mandates and governance structures to state banks. Indeed, there is some research that indicates that once public banks are provided with clear mandates, strong governance structures, and the right incentives, they can play a positive role in

mobilizing savings, expanding access, and reducing credit pro-cyclicality. State banks have played an important countercyclical role in the recent financial crisis in many countries.

Good Practices and Examples

State-owned banks may play a useful complementary role in the provision of credit to SMEs. However, the successful cases usually involve legislation specifying clear mandates, sound governance structures with independent boards, clear performance criteria, the obligation to price loans according to risk, the obligation to generate a positive return, and the ability to recruit and retain qualified staff. In some cases, specific legislation or board directives stress that the bank will not compete directly with the private sector but will fill remaining gaps and target the segments that remain underserved.⁵⁸

Clear mandates and strong corporate governance standards are essential for deflecting political interference. The failure of many state banks is explained primarily by political interference, unclear responsibilities from the different stakeholders, and lack of independence of the board of directors. The government should appoint a shareholder representative, which can be a minister or a high-level commission with two or three ministers. The shareholder representative should appoint the members of the board and communicate the expectations and priorities of the government that should be addressed by the bank. The members of the board of directors should be appointed for a fixed period of time, with some overlap among members. The members of the board should be elected according to the needs of the bank, which requires expertise on SME lending. The board of directors should have the power to appoint and remove the CEO.

56 Rocha, Farazi, Khouri, and Pearce. 2011. "Bank Financing for SMEs in the MENA Region: Evidence from a Joint Survey of the World Bank and the Union of Arab Banks." Policy Research Working Paper 5607. March. The World Bank. Washington, DC.

57 See e.g. Micco, Panizza, and Yañez, 2004. "Bank Ownership and Performance" Inter-American Development Bank, Research Department Working Paper 518 OECD (2009); Farazi, Feyen, and Rocha. 2011. "Bank Ownership and Performance in the Middle East and North Africa Region." Policy Research Working Paper Series 5620. The World Bank, Washington DC; Micco, Panizza, and Yañez. 2007. "Bank Ownership and Performance: Does Politics Matter?" *Journal of Banking and Finance*. 31 (1): 219–41, and Levy-Yeati, Micco, and Panizza, 2007. "A Reappraisal of State-Owned Banks" *Economica* 7(2), 209–247, as well as the references provided therein.

58 Rudolph, Heinz P. 2009. "State Financial Institutions: Mandates, Governance, and Beyond." Policy Research Working Paper 5141. The World Bank. Washington DC.

BOX: EXAMPLES OF STATE BANKS PERFORMING THEIR SME FINANCE MANDATES**Example 1: The Development Bank of Canada**

The Development Bank of Canada (BDC) provides support to businesses in all stages of development, with focus on riskier segments than those targeted by commercial banks, including SMEs. Since 1944, the starting year, BDC has provided financing of CD 15 billion dollars, reaching about 28,000 SMEs. Because its pricing policy reflects the risk of the borrower, loans from BDC are generally more expensive than loans from commercial banks. BDC has pioneered innovative solutions for entrepreneurs. It was the first institution to offer flexible long-term loans to businesses and one of the first banks to offer an integrated approach to small business development through financing and advice. While its non-performing loans are higher than those of its peers due to higher-risk clients, revenues are sufficient to ensure a positive return on equity – BDC is legally required to generate a return at least equal to the long-term government cost of funding. BDC played an important countercyclical role during the financial crisis: its lending increased by about 50 percent in 2010 through replacement of departing lenders in syndicated arrangements; it participated in new deals on a 50/50 basis; it purchased commercial mortgages; and it created a line of credit guarantee. In addition, BDC supported a government program for purchasing asset-backed securities. Although BDC increased its risk tolerance during the crisis, it was able to continue generating positive returns due to its sophisticated risk management system.

Example 2: Chile's Banco Estado

Banco Estado targets SMEs and segments of the population not generally served by commercial banks. The Chilean government supported Banco Estado in its early years, but later transformed it into an autonomous bank. Banco Estado has since competed in an open financial market and reinvests its profits for growth. Pricing policy is based on market references and the bank is forbidden by law to subsidize credit operations or lend to state institutions. Banco Estado is required to have a return on equity aligned with the average of the banking industry. In association with private partners, Banco Estado has been efficient in using its wide branch network to provide access to SMEs and low-income households. During the financial crisis, Banco Estado played an important countercyclical role by providing credit to companies and individuals that had lost access to credit. This role is reflected in an increase in its market share from 13 to 16 percent of total assets between December 2008 and November 2009. The sound financial position of bank at the beginning of the crisis and the timely capitalization of the bank (USD 500 million) were essential for enhancing its lending capacity and filling a countercyclical role.

Example 3: Morocco's *Crédit Populaire*

The *Crédit Populaire du Maroc* (CPM) has succeeded in serving SMEs thanks to its proximity to clients and a unique governance structure adapted from the French *Banques Populaires*. It is one of the largest Moroccan banks, accounting for one fourth of the nation's banking assets. SME finance has been a significant source of profits due to a reasonable credit quality, effective pricing, and an inexpensive funding base. A specific law lays out the foundations for effective governance by clearly defining the CPM's mandate and establishing checks and balances between the head office and its cooperative members. The CPM group includes a listed joint stock bank (*Banque Centrale Populaire* (BCP)) and 10 regional cooperative banks (*Banques Populaires Régionales* (BPR)), responsible for most retail activities, including SME finance. The State is the main shareholder of the group, but a reform implemented in 2000 enhanced the role and influence of the regional cooperative banks. These are medium-sized regional institutions owned by their customers and with strong ties to their regions, defining BPR's strategies and products. Economies of scale are achieved by developing systems at the group level (e.g. for Basel II implementation) while ensuring they are tailored to local needs.

State banks will only be able to perform their SME finance mandate effectively if they have in place proper lending and risk management technologies. This requires the presence of adequate human capital and operational systems that allow them to measure and price risks fairly. In order to ensure efficiency, state banks should be free to set their compensation policies and compete with other banks for qualified staff, and not be submitted to public sector employment practices and wage scales. The box on page 51 provides examples of three state banks that have performed reasonably well with their SME lending mandates.

Challenges and Priorities for LDCs

The enabling environment for finance in LDCs tends to be quite weak, due to deficient institutional and legal frameworks, poor financial infrastructure, and limited supervisory capacity. These conditions tend to imply more frequent and severe market failures that would justify more policy interventions, but the same conditions also imply a more limited capacity to implement these interventions effectively.

There are no easy solutions to this policy conundrum. Arguably, credit guarantee schemes may be a more effective mechanism than state bank lending to expand access to SMEs in LDCs, as the schemes are probably offered in middle-income countries. In the LDCs where state banks already exist and perform an access role, or where they are being created, policy-makers must follow the same best practices that have been identified for this type of intervention, and possibly take additional precautionary measures to avoid excessive political interference in these banks. The next section identifies good practices and examples for state bank interventions, while the last section identifies some additional measures and options for LDCs.

As in the case of middle-income countries, if there is a rationale for a market intervention to expand SME finance in LDCs, it is possible that this could be better

achieved by a well-designed credit guarantee scheme than by a new state bank (see next section). In the cases where state-owned banks already exist and play a role in SME finance, the first priority should be to ensure clear mandates and governance structures. It is preferable to have a specialized SME state bank funded by the budget and/or donors than a deposit-taking bank. Although there is no evidence that specialized state banks perform better than deposit-taking state banks, this construction would limit the potential damage that could be caused by excessive political interference and/or the limited regulatory and supervisory capacity in LDCs.

In the LDCs where there is a state bank operating side by side with a credit guarantee scheme, the role and target markets of the two institutions should be well defined.

C.3.2: APEXES AND OTHER WHOLESAL FUNDING FACILITIES

Second-tier institutions or funding facilities that channel funding (grants, loans, guarantees) to multiple providers in a single country or region are widely used to support the development of microfinance and SME finance. These “apex” facilities are attractive because they permit donors to pass the difficult and time-consuming task of SME selection to a local institution that is assumed to have the requisite skills. However, they have a mixed track record in terms of effectiveness, results, and fund utilization. Their main funding instrument is local currency debt. They are mostly funded by governments, international donors, or a mix of both.⁵⁹

Standards, Best Practices, and Examples

Direct lending in the form of soft loans/line of credit/co-financing/equity funds will likely continue to be a popular intervention in the SME finance space due to its simple structure and faster implementation. However, the impact of many of these programs has been limited due to the subsidy and political components associated

59 Sources: CGAP Brief: “Apexes: An Important Source of Local Funding”, March 2010, and 2011 ongoing CGAP Apex research.

with them. More research needs to be conducted on the impact of the variety of directed lending programs that have been implemented globally. Furthermore, guidelines for designing such programs should be developed in order to maximize their impact while minimizing the subsidy component, political interference, and crowding-out effects on the private sector. To further minimize their market distorting effect, an optimal exit strategy for such programs is also necessary.

In the case of apex funds for micro and SME finance, research has suggested several preconditions for successful application of the apex model. These include:

- Funding the development of sustainable finance providers (such as banks), including building capacity and technical expertise of the apex staff and of its clients;
- Ensuring the apex institution has a strong independent governance structure able to guarantee delivery of its mandated functions;

APEX “LESSONS LEARNED”⁶⁰

- Apexes have been effective where they have set high performance standards for their financing to financial institutions (FIs), thus focusing investment on only the highest potential FIs that have the capacity to build large-scale, financially viable operations.
- Apexes have contributed to the sustainable growth of institutions that provide access to finance for poor households and SMEs. In some cases, apexes have contributed to overheated markets by putting too much emphasis on disbursements and outreach rather than quality.
- Some apexes have gone beyond their role as a wholesaler in contributing to the growth of microfinance industries, for example by building the institutional capacity of the institutions to which they lend or by playing an important role in the elaboration of new regulations.
- Apexes have often funded too many institutions that had limited chances of becoming sustainable. It is important for apexes to select the right institutions and to have the appropriate tools to measure the performance of their clients. Technical assistance and training should be provided to FIs in order to increase the absorption capacity, growth potential, and sustainability of the microfinance sector. However, grants for technical assistance represent a very small percentage of overall apex funding and apexes do not always have the internal capacity to take on that function.
- Financing should fit each FI and bank’s cash-flow needs, institutional capacity, and past performance.
- High quality apex management and well-trained staff are key to success.
- Apex boards must be sufficiently independent from political influence, and include members from the private sector or civil society.
- When managed well, apexes can crowd commercial investment for FIs by demonstrating their repayment capacity at commercial interest rates.
- Funding from apexes can prove useful in times of international liquidity squeezes, as was the case during the global financial crisis.
- As markets mature, apexes need to look for ways to add value and a positive market development role. Apex institutions can be considered as local development finance institutions with a role of filling market gaps and spurring on market development for the benefit of the un-banked poor and SMEs.

60 Sources: Duflos, Eric & El Zoghbi, Mayada “Apexes: An Important Source of Local Funding”, March 2010, (<http://www.cgap.org/p/site/c/template.rc/1.9.43025/>) and Forthcoming: Forster, Sarah and Duflos, Eric “Reassessing the Role of Apexes: Findings and Lessons Learned”, CGAP 2011; Pearce, Douglas, 2002, “Lessons Learned from the World Bank -supported Apex Facility in Bosnia”; 2009, “Focus on Apexes”; Levy, Fred, 2001, “Apex Institutions in Microfinance”; CGAP Occasional Paper, No. 6. Also: Vega, Claudio Gonzalez, 1998, “Microfinance Apex Mechanisms: Review of the evidence and policy recommendations.”

- Applying a funding policy based on clear selection criteria, such as portfolio quality, depth of outreach, management quality, and progress toward eventual sustainability (along with the authority to discontinue funding to institutions that fail to meet these criteria);
- Offering commercial interest rates;
- Ensuring that the apex does not create over-heating through unsustainable growth in SME lending, that could lead to SME borrower over-indebtedness;
- Providing the capacity to evolve and adapt its mission and products according to market maturity;
- Including flexible and market reactive disbursement plans, and;
- Providing high quality operational management and staff skills.

Challenges and priorities for LDCs

Apexes can be a powerful tool to advance financial access to SMEs and poor households, in particular when the regulatory environment for the sector is still weak, and they are increasingly favored by

SUCCESSFUL EXAMPLES OF APEX FACILITIES

South Asia Regional Apex (SARA) Fund (India)

South Asian Regional Apex Fund (SARA), launched in 1995, is a \$25 million fund primarily focused on growth investments in SMEs engaged in technology, manufacturing, media, and retailing. Contributors to the SARA Fund include multi-lateral institutions like IFC in Washington, Japan Bank for International Corporation, Asian Development Bank, and Indian institutions like ICICI, Industrial Development Bank of India, Small Industries Development Bank of India, and Punjab & Sindh Bank.

While the Fund was originally conceived with a development orientation, and had a specific allocation for smaller developments in early stage companies, the portfolio was optimized, and since mid-1998, SARA has invested across technology, media, distribution, biotechnology, and telecommunications. SARA is currently invested across 26 companies to which it is fully committed. The Fund has exited from 19 of its investments, generating a gross return of 15 percent for its contributors.

Funding Facility – European Union (EU) and European Bank for Reconstruction and Development (EBRD) SME Finance Facility

The EU and EBRD SME Finance Facility is a regional facility, created in 1999, consisting of EBRD-funded loans to participating financial intermediaries (banks or leasing companies) in order to on-lend to eligible SMEs for investment and working capital needs. EBRD supports the loans with comprehensive technical assistance programs, and grants funded by the EU are aimed at developing the capacity of FIs to engage in SME finance on a sustainable basis. As a result, EBRD funds have financed over 100,000 loans, with an average individual loan size of USD 30,000. Technical assistance funds have been used to train more than 7,300 FI staff across all areas of their business (sales, credit analysis, management, back-office support, etc.). The FIs graduate from the EU grant support under the Facility after 5 years, and the majority of these institutions continue to provide finance to the SME segment as a key strategic market.

Funding Facility – European Investment Bank SME APEX Facility (Turkey)

The facility was designed to provide medium- to long-term finance for fixed asset investments of SMEs. The loan was secured from the European Investment Bank and TSKB, a privately owned Turkish development bank, which designed the structure and was the borrower of the loan. Turkey's treasury guaranteed TSKB's obligations and TSKB acted as wholesale (APEX) bank, providing credit lines to approved banks and leasing companies (AFIs) for on-lending to SMEs. AFIs manage project risk assessments and submit loan/leasing applications to TSKB. Minimum leasing/loan maturities are 4–6 years (including a 1-year grace period) and loans up to 50 percent of investment cost. The program financed USD 216 million to almost 350 SMEs.

governments and public funders. In several countries (e.g., India, Bangladesh, Colombia, Mali, Afghanistan) they have contributed to increasing financial access. But poorly designed apexes can waste time money and fail to meet their own goals. While each country has a different context that affects the success of an apex, the lessons outlined above can help governments and funders avoid major pitfalls.

C.3.3 PARTIAL CREDIT GUARANTEE SCHEMES

Many countries operate partial credit guarantee schemes (PCGs). In developed countries, such schemes have been operational for several decades, while their use in developing countries is more recent. Credit guarantee schemes can be organized in different ways but their core objective is the same: to guarantee the loans offered by a financial institution to a borrower subject to both the payment of a premium and a range of other rules and conditions. When default occurs, the lender is compensated by the guarantor as per the initial agreement. In some arrangements, the guarantor can benefit from a counter-guarantee from a higher level guarantee institution that is also subject to the payment of a premium.

Credit guarantee schemes are one of the most market-friendly types of interventions, as private financial institutions usually retain a primary role in the screening of borrowers and final lending decision. Unlike other types of interventions, such as state banks or directed lending arrangements, they may generate fewer distortions in the credit market and may lead to better credit allocation outcomes⁶¹). Guarantee schemes may prove an effective vehicle for reaching underserved groups such as start-ups and small firms. They may also generate positive externalities by encouraging banks to get into the SME market and improving their lending and risk management systems. Guarantee schemes have also been used for countercyclical

purposes and the recent financial crisis highlighted the importance of this countercyclical role.

Credit guarantee schemes can be organized in different ways, such as mutual guarantee institutions, credit guarantee banks, or credit guarantee funds owned and operated entirely by the public sector or by a combination of public and private shareholders. Some countries maintain different types of credit guarantee schemes.

Mutual guarantee institutions are typically private institutions with a mutual legal structure created by the beneficiary SMEs. Their capital is provided directly by the SMEs that apply for a loan guarantee in the form of cooperative or mutual shares. Each member has equal voting rights in electing the general assembly and board of directors. Mutual guarantee institutions are usually run by entrepreneurs, bringing an SME perspective to risk assessment and management. They are very common in Europe but also exist in some emerging countries.

Guarantee banks are legally structured as private foundations or joint stock companies, and can be owned by a variety of private shareholders such as chambers of commerce and industry, commercial or savings banks, banking associations, and insurance companies. They can be regulated and supervised as other financial institutions. Guarantee banks are an important component of the German credit guarantee system.

Partial credit guarantee schemes created, funded, and managed by the public sector (the government and/or the central bank) are one of the most common types of guarantee schemes. They are usually legally independent entities and can be managed independently or by another public institution such as a state development bank or state development fund. In many cases, the ownership structure is mixed, combining the state, commercial banks, and other private shareholders. In a few cases, participating banks are the dominant shareholders.

61 Beck and De la Torre, 2006

Good Practices and Examples

To jumpstart and nurture SME lending in LDCs, policy-makers may consider the creation of a credit guarantee fund in partnership with the private sector and international donors. The guarantee fund should be a legally independent entity governed by a board of directors that comprises representatives from the government, the private sector (mostly banks), and donor agencies. It is important to engage participating banks early on to increase the fund's capital and ensure an effective use of the guarantees. It is also essential to engage international partners to ensure the required financial and technical assistance in the start-up phase. The credit guarantee fund should be supervised by the central bank.

The credit guarantee fund should operate with simple and transparent rules and procedures. The final decision on the applications should not exceed two weeks. Eligibility criteria should be transparent, possibly based on turnover or number of employees. The board will have to decide, however, whether it is ready to accept applications from early start-ups with no performance history. This is a non-trivial decision that has to be made locally. The board will also have to decide whether the decision on the approval and rejection of the guarantee will be disclosed to the borrower. The Afghani and Palestinian guarantee schemes discussed in the box on page 57 do not disclose this decision to the borrowers in an attempt to avoid moral hazard, but there are advantages in maintaining an open and transparent application and decision-making policy.

Partial credit guarantee schemes structured as separate funds and owned by the public or private sectors are one of the most common forms of guarantee schemes worldwide. There is no research comparing the performance of state versus private-controlled guarantee schemes, but the presence of private banks in the ownership structure not only brings more capital to the scheme but may also generate other advantages such as

a business orientation and effective peer monitoring. The Lebanese Kafalat scheme is the largest SME credit guarantee scheme in the Middle East and North Africa region and provides a relevant example of a privately-owned scheme that has generated reasonable outcomes. It has a good outreach, has generated positive returns on equity for the past several years, and has retained and reinvested all of its profits in newly issued guarantees.⁶²

Legal and ownership structures are important aspects of a guarantee scheme, but the effectiveness of any scheme will also depend fundamentally on its rules and procedures, such as eligibility criteria, fees, coverage ratios, and payment rules. Guarantee schemes may add limited value and prove costly when they are not designed and implemented carefully. Loose criteria, low fees, and overly generous coverage ratios and payment rules may result in the provision of guarantees to enterprises that would have obtained credit anyway. They may also result in financial imbalances requiring large and recurrent government contributions.

The optimal design of a credit guarantee scheme depends to a good extent on country-specific conditions, including the quality of the legal framework and financial infrastructure, as well as the sophistication of lending institutions. However, reviews of credit guarantee schemes worldwide have identified a number of general principles that should be considered by all schemes in order to ensure positive outcomes, including outreach (number of credit-constrained SMEs that benefit from the scheme), additionality (capacity to target guarantees to credit-constrained SMEs), and financial sustainability (capacity to avoid excessive net losses and recurrent recapitalizations by the state).

The box below summarizes the key features of well-designed guarantee schemes, while the box on page 57 provides specific examples of well-designed schemes in high-, middle-, and low-income countries (Chile, West Bank and Gaza, and Afghanistan).

62 Saadani, Youssef, Zsofia Arvai, and Roberto Rocha (2010) provide a review of PCGs in the Middle East and North Africa region.

BOX: EXAMPLES OF CREDIT GUARANTEE SCHEMES**Example of an Upper-Middle-Income Country: FOGAPE (Chile)**

FOGAPE is a partial credit guarantee scheme operated by Banco Estado, a large state-owned bank in Chile (see previous section). It provides partial guarantees on SME loans extended by commercial banks and counter-guarantees to mutual guarantee associations. FOGAPE targets SMEs who lack collateral or need longer maturities. FOGAPE functions in many aspects as a traditional guarantee scheme by sharing the risk of default on eligible loans and charging a guarantee premium. However, FOGAPE is also unique by having pioneered a new approach for allocating guarantees among participating banks. Every year FOGAPE conducts four to six auctions where each bank submits a bid indicating the amount of guarantee it wants to receive and the minimum coverage ratio it is willing to accept. Coverage ratios fluctuated around 70 percent before the financial crisis, increased to about 80 percent during 2009 and 2010, but recently declined to pre-crisis levels. Banks pay a premium that depends on their historical default and claims performance and that typically varies between 1 and 2 percent of the outstanding balance. Banks with high default rates can be excluded from the scheme. FOGAPE has been financially sustainable, due to the auctioning of coverage ratios, the risk-related fees, and a very reasonable average net loss ratio of 1.5 percent of guarantees. A number of empirical studies have concluded that the scheme provides additionality and has a positive developmental impact. During the financial crisis, the Chilean Government increased FOGAPE's capital by a significant amount to enable the scheme to play a substantive countercyclical role. In 2010 FOGAPE's volume of guarantees to MSMEs reached USD 1.8 billion for a total financing of around 2.7 USD billion.

Example of a Lower-Middle-Income Country: The European-Palestinian Credit Guarantee Fund (West Bank/Gaza)

The European-Palestinian Credit Guarantee Fund (EPCGF) was created in 2005 and funded by the German Government, the European Commission, and the European Investment Bank. It was designed to jumpstart SME lending in a very challenging environment that had resulted in very limited bank lending and practically no lending to SMEs. It targets SMEs with less than 20 employees but avoids start-ups due to the perception of excessive risks in this segment. The scheme provides a coverage ratio of 60 percent, a maximum loan amount of USD 100,000, and a 1 percent up-front fee complemented by a 1.5 percent annual commission on the outstanding guarantee. It provides guarantees on loans with maturities from 1 to 5 years and does not impose interest rate caps. It has streamlined procedures for approval of guarantees and payment of claims that enhanced its credibility among banks. The guarantees are not disclosed to the borrowers in order to enhance discipline.

Example of a Low-Income Country: The SME Credit Guarantee Facility for Afghanistan (Afghanistan)

The SME Credit Guarantee Facility for Afghanistan was created in 2005 and funded by the United States Agency for International Development (USAID) and the German Government. Like its Palestinian counterpart, it was created to jumpstart SME lending in a challenging environment and shares some of characteristics. It provides a coverage ratio of 72 percent, charges risk-related fees, does not impose interest rate caps, and does not disclose the guarantees to the borrowers to enhance discipline. Also like the Palestinian scheme, it introduced from the start a substantive capacity-building program, including assistance to the establishment of dedicated SME units in the banks. It succeeded in boosting SME lending from negligible levels and has an NPL ratio of only 1.3 percent of the outstanding stock of guarantees. The program has provided financing for USD 37 million, reaching more than 1,200 SMEs.

Mutual guarantee institutions have a similar structure in most European countries and seem to have contributed to more access to credit and lower interest rates for participating SMEs. However, recent research of Italian mutual guarantee institutions also shows that these institutions produce better outcomes where they remain local and private. An increase in the number of firms/shareholders tends to create free riding problems and erode the positive selection and peer-monitoring effects. The increased participation of the state in the

funding of mutual guarantee institutions also tends to erode peer monitoring and payments discipline.⁶³ These are important findings for other countries envisaging this type of guarantee scheme.

Challenges and Priorities for LDCs

As mentioned in the preceding section, the enabling environment for finance in LDCs tends to be weak, due to deficient institutional and legal frameworks,

BOX: KEY FEATURES OF WELL-DESIGNED CREDIT GUARANTEE SCHEMES⁶⁴

Eligibility criteria: Guarantee schemes should target SMEs through reasonable ceilings on turnover, number of employees, and/or size of the loan. However, restrictions on sectors or types of loans should be avoided.

Approval rules and procedures: Approval procedures should be streamlined and result in final approval or rejection of the application within a period of two weeks.

Collateral and equity rules: PCGs should be allowed to require collateral, although subject to reasonable limits, and should be allowed to require minimum equity for riskier exposures.

Coverage ratios: Coverage ratios should ensure sufficient protection against default risk while maintaining strong incentives for effective loan origination and monitoring. Coverage ratios ranging from 50 to 80 percent are common, with ratios typically increasing with the maturity of the loans (lower for working capital loans, higher for investment loans) and decreasing with the age of company (higher for start-ups, lower for more established firms).

Fees: Fees should be risk-based and contribute to the financial sustainability of the scheme.

Payment rules and procedures: Payment rules should take into account the effectiveness of the collateral and insolvency regimes. Schemes in developed countries can base payments on realized losses, but schemes in most emerging countries need to base payments on default events while ensuring incentives for effective debt collection.

Risk management: Strong risk management capacity is key to ensure that guarantees reach targeted borrowers and ensure the financial sustainability of the scheme.

Capacity building: PCGs can play a fundamental capacity building role in LDCs, for SMEs, and commercial banks.

Evaluation mechanism: Comprehensive evaluation mechanisms are best practices to measure a PCG scheme's achievements in terms of outreach, additionality, and sustainability.

Supervision: Many PCGs are supervised by central banks in order to ensure the soundness of their operations.

Risk weighting for banks' prudential requirements: A well-designed and financially robust guarantee scheme should allow bank regulators to assign a lower risk weight to exposures that are covered by the guarantee.

63 Columba, Francesco, Leonardo Gambacorta, and Paolo Emilio Mistrulli. 2009. "Mutual Guarantee Institutions and Small Business Finance." BIS Working Papers No. 290, Bank of International Settlements, Basel.

64 See, e.g., Green, Anke. 2003. "Credit Guarantee Schemes for Small Enterprises: An Effective Instrument to Promote Private Sector-Led Growth?" Working Paper No. 10, United Nations Industrial Development Organization; available at http://www.unido.org/fileadmin/import/18223_PSDseries10.pdf; and Saadani, Youssef, Roberto Rocha and Zsofia Arvai 2010, "Assessing Credit Guarantee Schemes in the Middle East and North Africa," World Bank, available at <http://blogs.worldbank.org/files/allaboutfinance/MENA%20Flagship%20Credit%20Guarantee%20Schemes%20Final.pdf>

poor financial infrastructure, and limited supervisory capacity. Well-designed and targeted policy interventions may be well justified in these cases. Moreover, credit guarantee schemes may be one of the most effective mechanisms to address market failures and expand SME lending, as they rely primarily on private banks for screening and monitoring potential SME borrowers.

At the same time, the low institutional development and human resource constraints of LDCs imply a limited capacity to run these schemes effectively. In addition, private banks may have better incentives than state banks to screen and monitor potential borrowers, but may lack the human resources and technologies to conduct these activities effectively. These limitations have important implications for the formulation of the objectives of guarantee schemes in LDCs, as well as the design of their rules and procedures. More specifically, capacity building should be one of the key objectives of PCGs in LDCs. Also, the low institutional capacity of LDCs implies the need for simpler scheme designs. Finally, introducing effective guarantee schemes in LDCs requires substantial technical assistance from donors, especially in the early stages of implementation. Afghanistan and Palestine provide relevant examples of PCGs that have performed well in challenging environments.

C.3.4 GOVERNMENT PROCUREMENT FROM SMES

The public sector is a significant buyer of services and goods from SMEs, with common examples being repair and maintenance contracts, office supplies, catering supplies, transport services, and so on. Governments also provide indirect payments in the form of benefits, salaries, or pensions, to households of SME entrepreneurs. SMEs have potential to use invoices and supply contracts with the public sector, as with the private sector, to secure access to financing, for example through factoring, or through use of the contract as collateral for a loan. The

SMES' ACCESS TO PUBLIC PROCUREMENT IN THE EU

A recent European Commission study estimates the total value of contracts awarded in the EU for the period 2006-2008 at about 876 billion euro. From this total, the estimated total value of contracts awarded to SMEs is 34 percent. The differences among countries are large. Countries with high SME shares are Bulgaria, Latvia, Malta, Luxembourg, and Greece, ranging from 79 percent in Bulgaria to 52 percent in Greece. Countries with low SME participation are Czech Republic, Spain, Portugal, and the United Kingdom, all with less than 25 percent. As a general trend, SMEs are more dominant in smaller countries.

The share of SMEs in public procurement is 18 percentage points lower than their overall share in the EU economy, calculated on the basis of their combined turnover (52%). But performance differs according to SME size. While the medium-sized enterprises' share of public procurement (17%) is close to their share in the economy (19%), the micro and small enterprises lag considerably behind their role in the economy. Micro-enterprises account for about 6 percent of the contract value in public procurement versus a 17 percent of total turnover, while small enterprises trail behind by 5 percentage points. This indicates that micro and small firms face more barriers to accessing public contracts than do medium-sized firms.

Source: Evaluation of SMEs' access to public procurement markets in the EU, 2010

government can introduce mechanisms to facilitate this access to finance, as outlined in this section.

Governments can also adopt a critical lesson learned from the recent global financial crisis, which is that by paying SMEs promptly, and expanding the proportion of goods and services procured from SMEs, governments can contribute directly to SME creditworthiness and viability. For example, as a result of the global financial crisis, SMEs in OECD countries were confronted with a decrease in demand for goods and services, and an increase in payment delays on receivables. This resulted in a shortage of working

FACILITATING BUSINESS TRANSACTIONS THROUGH PUBLIC TRADING PLATFORMS: CHILE COMPRA

Chile Compra is a public, electronic system for purchasing and hiring that started operations in 2003. It is based on an internet platform and caters to companies, public organizations, and regular citizens alike. Currently, Chile Compra is the largest business-to-business site in Chile, with more than 850 purchasing organizations, including businesses, government ministries, public services, hospitals, municipalities, the military, the Lower Chamber of the Chilean Parliament, and universities.

In an average month, 40,000 companies are registered and more than 150,000 business negotiations transacted. A total of 8,141 government employees use this system. During 2010, registered companies announced 365,397 purchases and issued 1,894,477 purchase orders. 2010 ended with US\$6.5 billion in transactions.

Registered companies are mostly microenterprises (68 percent of the total) and SMEs (29 percent). Large firms only make up 3 percent. However, large firms provide 45 percent of the total volume purchased, SMEs 37 percent, and microenterprises 18 percent. The share of micro and small firms is remarkable, as their participation in government purchases is double their overall share in the Chilean economy.

The Chile Compra system is exposing some of the myths associated with the use of advanced technology, by actively involving everyday people, and low-income microenterprise operators, who are entering the electronic trade platform.

Sources: Rioseco, and Andrés Navarro Haeussler. 2006. "Information and Communication Technologies in Chile: Past Efforts, Future Challenges." Global Information Technology Report 2006, Hampshire: Palgrave, Macmillan. pp. 71-87. Analiza Chile Compra webpage.

capital and decrease in liquidity. According to an OECD study,⁶⁵ 43 percent of surveyed SMEs in Belgium experienced extended delays in their receivables, and in the Netherlands 50 percent of SMEs have to deal with longer payment terms from their customers. In New Zealand, the share of enterprises waiting over 60 days for payment rose dramatically from 4.8 percent to 29.5 percent between February 2007 and 2008.

Good Practices, Examples

Governments can stimulate factoring and other sources of supply chain finance by creating a supportive regulatory and legal environment, such as electronic security and signature laws necessary for the quick and electronic sale of accounts receivable. Market structures, or platforms, can also be set up to facilitate supply chain and factoring transactions with SMEs.

Mexico's NAFIN platform for factoring and value chain finance (outlined in section C.1.3), includes

government invoices and contracts with SMEs. NAFIN facilitates a form of "reverse" factoring, whereby SMEs access finance based on the buyer's creditworthiness, as well as access to earlier stage supply chain credit. SMEs can also register as providers to the public sector, and access information, e-learning, and contracting opportunities through the NAFIN platform.

In Chile, the electronic system for government purchases known as "Chile Compra" served as an important tool in the government countercyclical policy to support SMEs. Chile Compra successfully addressed the objective of facilitating access of the domestic small companies to government purchases opportunities. The share of MSMEs in the total volume of purchases increased from 49 percent in 2007 to 55 percent in 2010. The share of SMEs in government purchases is almost double the figures for the whole economy. Chile Compra contributed with savings of \$180 million on government purchases and decreased suppliers transaction costs by \$65 million in 2009. Further, the public

65 The Impact of the Global Crisis on SME and Entrepreneurship Financing and Policy Responses. OECD 2009.

market contributed with 50,000 direct jobs and about 200,000 indirect jobs in 2009.⁶⁶

To address the problem of payment delays by government to SMEs, and the possibility that delayed payments might lead to insolvencies, specific measures introduced by some OECD countries are:

- i) Legal moves to shorten payment delays and enforce payment discipline (France); and
- ii) Reduction of government payment delays (Australia, France, Hungary, Italy, the Netherlands, New Zealand, and United Kingdom).

For example the U.K. government has cut payment delays to 10 days. Other governments are paying their SMEs suppliers within 30 days or less, and the European Commission is revising the directive on payment delays in view of improving payment behavior.⁶⁷

Challenges and Priorities for LDCs

This approach can have particularly high impact where SMEs are not well connected to supply chain finance, as is the case in many LDCs. Governments can use their role as buyers of goods and services from SMEs to link those SMEs to factoring, discounting, and contract-based financing. This in turn links SMEs to financial services more broadly as an indirect result of improving their credit record.

While some countries are already reforming the public procurement rules to provide a level playing field for SMEs bidding for public contracts,⁶⁸ significant efforts may still be required to change public procurement practice and dismantle many barriers that discourage SMEs from responding to tenders or even lead them to avoid such

opportunities altogether. These include difficulties in obtaining information, lack of knowledge about tender procedures, the large size of the contracts, a short time span to prepare proposals and the cost of preparing them (since many costs are fixed, SMEs face disproportionately high costs in comparison with larger enterprises), high administrative burdens, or unclear jargon used in tenders.

C.3.5: SME CAPACITY, CREDITWORTHINESS

SMEs create jobs and income, contribute to poverty reduction, and help build a market-oriented economy. While SMEs are a major source of employment and income for all countries, they are particularly important in developing economies, where SMEs have the largest share of employment and job creation.⁶⁹ SMEs typically represent more than 90 percent of all firms outside the agricultural sector⁷⁰ and are responsible for more than 60 percent of employment and 60 percent of GDP in developing economies.⁷¹

The importance of SMEs in developing markets contrasts with the multitude of constraints they face. Developing-economy SMEs face an inter-related set of barriers that hamper their productivity growth, and thus their ability to contribute to economic and social development. Barriers to SME development fall into three general categories: business environment, know-how, and finance.⁷² Problems in any one category tend to compound the obstacles in other areas. For example, limited managerial skills impede access to financial resources, and a poor business climate discourages SMEs from investing in competitiveness.

Research suggests that firms in emerging markets tend to have poorer management practices than those in

66 According to the Chile Compra Strategic Plan 2010-2012.

67 See The Impact of the Global Crisis on SME and Entrepreneurship Financing and Policy Responses. OECD 2009

68 Such as the 2004 EU Directives reforming the public procurement rules

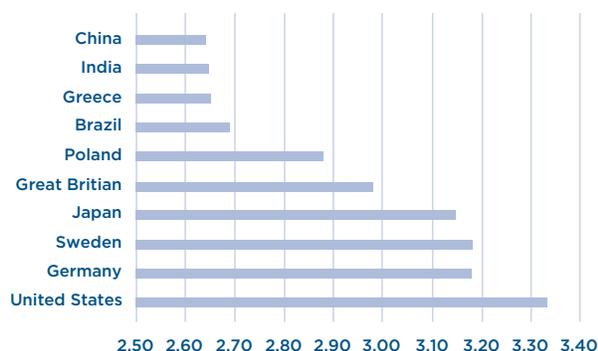
69 Meghana Ayyagari, Asli Demirguc-Kunt and Vojislav Maksimovic, "Small vs. Young Firms across the World: Contribution to Employment, Job Creation, and Growth," The World Bank Development Research Group (April 2011): 4.

70 "Promoting SMEs for Development: The Enabling Environment and Trade and Investment Capacity Building," DAC Journal, Vol. 5, No. 2 (2004): 29.

71 "Why Support SMEs?" International Finance Corporation, World Bank Group (2010): 3.

72 Michael Klein, "Promoting Small and Medium Enterprises: Their Importance and the Role of Development Finance Institutions in Supporting Them," The Atrium Dialogues, DEG KfW Bankengruppe (November 2010): 12-13.

FIGURE 3 MANAGEMENT SCORES ACROSS COUNTRIES



Source: Bloom and Van Reenen (2010) Management scores, from 1 (worst practice) to 5 (best practice)

developed economies.⁷³ Figure 5 highlights this gap in managerial skills between developed and developing markets.

Several recent studies clearly demonstrate the impact of capacity building on management performance. For example, access to management training and consulting improved the productivity and increased the profitability of SMEs in the textile industry in India.⁷⁴ Similarly, a group of micro businesses and SMEs in Mexico saw increases in productivity, sales, and profitability after participating in management consulting.⁷⁵ The conclusion is that managerial capital can be transmitted through such capacity-building services as training and

EXAMPLE: MANAGEMENT MATTERS – EVIDENCE FROM INDIA AND MEXICO

A longstanding question in management science is whether differences in firm performance can be attributed to differences in management technique – does management matter? Several researchers have sought to answer this question by conducting experiments with small businesses in emerging markets.

Bloom et al. investigated the impact of improved management practices on firm outcomes in India's textile industry. They offered free management consulting to 28 textile plants and compared the performance of these plants against a control group that did not receive consulting services. The researchers observed that the firms that engaged management consultants increased productivity on average by 10.5 percent and profitability by 16.8 percent, primarily through higher efficiency and lower inventory levels. The study also found that lack of information was a key barrier to adoption of modern management practices. This suggests that training programs have a role to play in helping firms understand first how quality control, planning, and inventory management (among other practices) can improve business performance in general, and then how such practices can be applied profitably to their specific businesses.

A similar study was carried out by Bruhn et al. in Puebla, Mexico, where micro businesses and SMEs (MSMEs) were offered subsidized management consulting services. Participating firms spanned the manufacturing, commerce and trade, and services sectors. Compared to a control group, firms that received management consulting saw a significant increase in their productivity and return on assets. Sales and profits also increased by more than 70 percent on average for those that worked with consultants (though this was influenced by a few outliers). The investigators even witnessed an improvement in intermediate business process variables: firms in the treatment group were 13 percent more likely to have launched a new marketing campaign and 7 percent more likely to keep formal accounts.

Sources: Nicholas Bloom, Nicholas, Benn Eifert, Aprajit Mahajan, David McKenzie and John Roberts, "Does Management Matter? Evidence from India," The World Bank Development Research Group (February 2011).

Miriam Bruhn, Dean Karlan, and Antoinette Schoar, "Returns to Management Consulting for Micro, Small and Medium Size Enterprises in Mexico," Innovations for Poverty Action.

73 Nicholas Bloom and John Van Reenen, "Why do Management Practices Differ across Firms and Countries?" *Journal of Economic Perspectives*, Vol. 24, No. 1 (2010): 209.

74 Nicholas Bloom, Benn Eifert, Aprajit Mahajan, David McKenzie and John Roberts, "Does Management Matter? Evidence from India," The World Bank Development Research Group (February 2011).

75 Miriam Bruhn, Dean Karlan, and Antoinette Schoar, "Returns to Management Consulting for Micro, Small and Medium Size Enterprises in Mexico," Innovations for Poverty Action.

consulting. Improving SME business outcomes is a key reason to provide capacity building, as such improvements help generate economic growth and jobs.

Standards, Guidelines and Good Practice

An enabling business environment is the supporting architecture for a dynamic SME sector. Research from more than 45 developing and OECD countries indicates that when the enabling environment becomes more business friendly, SMEs will be able to build managerial capacity and access financial resources.⁷⁶ SME development “requires a crosscutting strategy”⁷⁷ that is embedded in broader national goals concerning, for example, economic growth, poverty reduction, and women’s participation in business. Such a strategy should promote responsible macroeconomic policies on inflation and exchange rates – fluctuations in both have been found to impact SMEs more than large businesses.⁷⁸ SMEs also benefit from an enabling microeconomic environment, which is the level at which firms interact with institutions, organizations, and markets. A sound microeconomic climate includes good governance, transparent legal and regulatory regimes, and access to a skilled workforce. Both macro and micro environments can improve SMEs’ capacity to launch competitive business strategies.⁷⁹

In SME market development, capacity-building services should be delivered to SMEs through experienced local partners (e.g., training firms, banks, and consultants) rather than by governments, development institutions, or donors. There are several benefits to this practice: i) it leverages the market knowledge of local intermediaries who are better positioned to meet SME needs; ii) it helps build markets for SME advisory services, rather than crowd out the private sector; and iii)

EXAMPLE: IFC’S BUSINESS EDGE – FILLING A GAP IN THE SME TRAINING MARKET

Business Edge is an IFC-owned training system designed to improve the management skills of SME owners and managers. This classroom-based program offers practical management training that is adapted to the local business context and delivered by a network of local partners. The goal of Business Edge is to improve the performance and competitiveness of SMEs in order to generate jobs and income in the local economy. By using a franchise model, IFC avoids distorting the market, instead acting as a facilitator to strengthen the capacity of local training providers.

Business Edge is a world-class training system that localizes global best practices in business management. The program consists of 36 different workshops and management workbooks in marketing, human resources, production and operations, finance and accounting, and productivity skills. It incorporates material sourced from the global market and is customized to fit the local business environment in terms of both training methodology and content (e.g., Arabic language plus local examples). Training providers are selected based on their track record in training and willingness to serve SMEs. Trainers use Business Edge materials as a core in structuring their own innovative training programs. IFC certifies the training providers and monitors their performance, thus ensuring that quality standards are upheld.

To date, more than 650 Business Edge trainers have instructed 137,000 individuals across 27 countries. The program has also helped brands like Microsoft and Novartis achieve their supply chain development goals.

it amplifies the number of enterprises reached, as well as the efficiency with which they are reached.⁸⁰ Such an approach leads to capacity-building services that are both sustainable and scalable. It works by creating

76 Michael Klein, “Promoting Small and Medium Enterprises: Their Importance and the Role of Development Finance Institutions in Supporting Them,” *The Atrium Dialogues*, DEG KfW Bankengruppe (November 2010): 4.

77 “Promoting SMEs for Development: The Enabling Environment and Trade and Investment Capacity Building,” *DAC Journal*, Vol. 5, No. 2 (2004): 42.

78 *Ibid.*, 43.

79 *Ibid.*, 43-44.

80 “Business Development Services for SMEs: Preliminary Guidelines for Donor Intervention,” *Summary of the Report to the Donor Committee for Small Enterprise Development* (January 1998): 8, 20.

EXAMPLE: START AND IMPROVE YOUR BUSINESS – ILO HELPS SMALL BUSINESSES REACH THEIR POTENTIAL

Since 1991, the International Labour Organization's (ILO) Start and Improve Your Business (SIYB) program has been helping would-be entrepreneurs launch and expand their businesses. The SIYB program is aimed at creating more and better employment opportunities in emerging markets through the development of the micro and small enterprise (MSE) sector.

Like IFC's Business Edge, SIYB strengthens – rather than displaces – the local market for capacity-building services. It relies on a network of qualified partner organizations (POs) to deliver business management training across more than 80 countries. The ILO has implemented a “train the trainer” model that ensures POs are qualified to provide training to MSEs.

Using appropriate adult training methodologies, SIYB takes enterprises through the entire process of starting and managing a business, beginning with a course on how to develop an idea for a business. The program continues with “Start Your Business,” an interactive module that walks entrepreneurs through the development of a feasible business plan. The third course, “Improve Your Business,” helps firms establish basic management systems, including financial management, costing and marketing. The final course, “Expand Your Business,” is aimed at MSEs that are growth oriented. It relies on training and other mechanisms to help businesses develop and launch a growth strategy.

Source: International Labour Organization, 2010 (www.ilo.org)

EXAMPLE: TURK ECONOMICI BANK – A FIRST MOVER IN PROVIDING NON-FINANCIAL SERVICES TO SMES

Turk Economici Bank (TEB) was among the first banks in Turkey to recognize that providing capacity-building support to SMEs could have enormous potential in building a client base of healthy businesses, increasing customer loyalty, and decreasing credit risk in the SME sector. In 2005, TEB began offering training services through its SME Academy. The primary goal of training is to build SME competitiveness and strategic planning capabilities. It also helps SMEs take a market-centric approach to their businesses, giving them the tools to identify and respond to new opportunities for products and services. In 2008, TEB began to complement its “low-touch” training with “high-touch” one-on-one management consulting delivered through a cadre of trained relationship managers.

TEB has emerged as a leader among Turkish banks in experimenting with innovative non-financial approaches to SME capacity building. Its capacity-building support has resulted in a decrease in loan delinquency rates in its SME portfolio, in addition to new client acquisition and greater customer loyalty. Driven by its success in Turkey, BNP Paribas (one of TEB's largest shareholders) has replicated aspects of this non-financial business model in other emerging markets.

Source: Turk Economici Bank, 2011

models that can be delivered by the private sector in a programmatic way on a regional or global basis.

Holistic Approach

The hurdles facing SMEs are complex and inter-related and therefore will not be solved by one type of intervention. The impact of access to finance can be amplified through greater managerial bandwidth. A private

sector example of a holistic approach is South Africa's Business Partners,⁸¹ an investment fund that targets small entrepreneurs in Africa. Its strategy hinges on assessing the technical assistance needs of potential clients and making their acceptance of an integrated program of support a condition of investment. In keeping with the principle of intermediary development, services are delivered by local partners, and not directly

81 Making Big Things Happen for Small Businesses: Annual Report 2011, Business Partners. Retrieved July 7, 2011 from <http://www.businesspartners.co.za/Finresults/AR2011.pdf>.

by Business Partners. Following this model of advisory services and financing, Business Partners has achieved real returns on investment of 7 to 9 percent on its SME portfolio for the past 10 years.⁸²

The integration of financial and capacity-building services can likewise be seen in the SME banking sector. Turk Economici Bank (TEB) illustrates how providing training and other forms of support to SME clients can benefit financial service organizations.

Challenges and Priorities for LDCs

Capacity-building activities have thus far had mixed results in developing economies. Market gaps remain in the provision of relevant support services to SMEs. This is due to both demand and supply issues. On the demand side, local SMEs might not be convinced of the relevance of such services and therefore might not be willing to pay – and even if they are convinced of the need, they might not have the ability to pay. On the supply side, there is a lack of relevant and affordable services in developing markets. Where services do exist, they are often delivered through lecture mode, thus limiting the transfer of skills to participants. Content might be confined to western approaches that are inappropriate for the local environment. Even when content and delivery mechanisms are suitable for the environment, service providers typically focus on large corporate entities, thus helping to perpetuate the “missing middle” of small- and medium-sized businesses in developing economies.

Much of the failure around capacity building has been the result of untargeted interventions that attempt to apply practices that work for one SME market segment to other segments. For that reason, recent efforts – such as those by IFC and the ILO – have focused on customizing content for particular groups of entrepreneurs (e.g., growth-oriented enterprises, women entrepreneurs,

and disadvantaged groups). These efforts, however, are often stymied by national agendas that neglect or even disempower certain segments of the population. For example, women play an important role in reducing poverty and contributing to economic and social objectives. In many developing countries, the SME sector employs large numbers of women (roughly 40 percent of African SMEs are owned or managed by women).⁸³ Yet national and local policies frequently place roadblocks to women’s full participation in the SME sector.

A related challenge concerns the tension between public and private interests. Good practice generally states that SME support services should be delivered by private organizations on a commercial basis. This approach, however, overlooks the economic role played by disadvantaged groups who might not have the resources to avail themselves of such services. A strictly demand-driven approach means that those with the most demand for the services – and ability to pay – will benefit more than others. For this reason, governments and other public sector bodies have a role to play both in financing the development of new interventions that benefit entire swathes of SMEs, and in raising SME awareness of the need for better management practices. Public-private partnerships (PPPs) are one way to ensure that capacity-development services are delivered by private actors for the benefit of private actors, while still meeting broader societal objectives. PPPs can address SMEs’ growth problems through the combined efforts of public, private, and development organizations working together to improve technological capabilities and human capital.

Benchmarking and program evaluation continue to pose challenges to SME support providers. Compared to fields like microfinance, relatively little has been done in capacity building to establish common metrics for performance assessment.⁸⁴ The need for tailored, context-specific interventions contrasts with the

82 Tom Gibson and Hugh Stevenson, “High-Impact Gazelles: Should They Be a Major Focus of SME Development?” (April 2011): 10.

83 Why Support SMEs?” International Finance Corporation, World Bank Group (2010): 16.

84 Business Development Services for SMEs: Preliminary Guidelines for Donor Intervention,” Summary of the Report to the Donor Committee for Small Enterprise Development (January 1998): 9.

desirability of scalable, standardized approaches that facilitate comparison between different service providers and different impacts. Donor agencies, development institutions, and service providers must work together to achieve the right balance between market segmentation and scalable business models that can be objectively assessed using quantitative indicators.

C.4: Women and SME Finance

In a recent study, McKinsey estimated the financial credit gap that women business-owners face to be between USD \$292 to 357 billion, representing 30 percent of the total SME credit gap for formal SMEs. Women entrepreneurs are also more likely to cite access to finance as the first or second barrier to developing and growing their businesses. In addition, relative to men, women tend to have less access to finance and other resources, along with issues of rights and voice.⁸⁵

Women entrepreneurs make significant contributions to their economies. Across regions, between a quarter and a third of registered small businesses have a female owner. These firms represent a significant share of employment and value added. However, the potential for greater growth of women's businesses is not always realized. While women's entrepreneurship is high in developing countries, it is largely skewed towards smaller firms. Women entrepreneurs are more likely to be in the informal sector, running smaller firms and operating in lower value added sectors than their male colleagues. They are more likely to be home-based and operate within the household than are male-headed enterprises.

With access to finance an important means to pursuing greater opportunities, addressing gender gaps in access to finance must be part of the development agenda. Across regions, women have lower access to finance than men. In addition to being less likely to have a loan, women often face less favorable borrowing

terms. Many country studies show that women entrepreneurs are more likely to face higher interest rates, be required to collateralize a higher share of the loan, and have shorter-term loans.

Both non-financial and financial barriers can contribute to gender gaps in access to finance. Non-financial barriers can include characteristics of the entrepreneurs (e.g., differential access to education or management training); conditions in the broader business environment that may differentially affect women's and men's businesses (e.g., the legal and regulatory environment or the quality of available infrastructure); and constraints within financial institutions and a country's financial infrastructure that limit incentives to reach out to more female clients.

Standards, Best Practices, and Examples

Building an effective policy guide to facilitate women's access to finance requires an understanding of the existing legal framework, in particular the extent to which it facilitates property ownership on both movable and immovable assets. Property ownership encompasses the ability to manage, control, administer, access, encumber, receive, dispose of, and transfer property. As such, consideration should be given to the extent to which the broader legal framework, including family codes and inheritance rights, enables women to own (and therefore use as collateral) land and movable assets. Another factor to examine is whether the law discriminates in other ways against women when they seek to access finance. For instance, in Cameroon, married women have no property rights. The civil code states, "The husband alone administers matrimonial property ... the husband shall administer all personal property of his wife"⁸⁶. Similarly, until very recently, women in Lesotho were considered as minors and thus were ineligible to undertake legal transactions in their own right. Considering the broader legal framework and its impact on women's ability to access loans will

85 Women, Business and the Law, World Bank, 2009

86 Articles 1421 and 1429 Cameroon civil code.

be critical in ensuring that women proportionally benefit from the reform efforts. Local women lawyers' organizations or NGOs promoting women's rights are often well placed to provide assistance in analyzing these issues.

The country's international treaty obligations and any guarantees of equality contained in the constitution should also be examined. If legal restrictions on women's property rights or ability to participate in credit markets conflict with these overarching obligations, the case for reform may be stronger. For instance, the Convention on the Elimination of All Forms of Discrimination against Women (CEDAW) requires states to ensure that women have equal rights to obtain bank loans, mortgages, and other forms of credit. The Beijing Platform for Action commits to providing

women with access to finance and credit, and eliminating biases against women in finance laws. The Protocol to the African Charter on Human and People's Rights on the Rights of Women in Africa commits states to create conditions to promote and support the occupations and economic activities of women.

In addition to international commitments, several countries extend nondiscrimination provisions enshrined in the constitution to apply in the private sphere. The U.K. Sex Discrimination Act of 1975 prohibits gender discrimination in private transactions to supply goods, facilities, and services, including credit. The U.S. Equal Credit Opportunity Act of 1974 prohibits discrimination on the grounds of gender or race in relation to credit applications. It was extended by the Women's Business Act of 1988 to include business loans.

IFC: WOMEN IN BUSINESS PROGRAM

IFC recognizes that aspiring businesswomen are often prevented from realizing their economic potential; IFC is committed to creating opportunities for women in business. Through its Women in Business (WIN) program (formerly known as Gender Entrepreneurship Markets), IFC aims to mainstream gender issues into its work, while helping to better leverage the untapped potential of both women and men in emerging markets. IFC provides financial products and advisory services to:

- Increase access to finance for women entrepreneurs;
- Reduce gender-based barriers in the business environment; and
- Improve the sustainability of IFC investment projects.

Thus far, IFC has worked with more than 16 banks to enhance their ability to provide more targeted products and services to women entrepreneurs. Through this intervention, IFC has invested over \$118 million, of which over \$86 million have been on-lent to women entrepreneurs. Well over 2,200 women entrepreneurs have had the opportunity to increase their business and financial management skills.

USAID's DCA (Development Credit Authority) and Kenya Commercial Bank

USAID partners with Kenyan financial institutions to encourage lending in areas that are under-served due to the perception of high risks. Under this partnership KCB - one of the Kenyan banks- has introduced the Grace Loan, which is tailor-made for individual women entrepreneurs and women business groups to meet their working capital or business expansion needs. Through the Grace loan, women are able to apply for a loan of up to \$62,000, repayable in up to 36 months. The loan also has an important training component. To access value added services, women entrepreneurs get the opportunity to join KCB's Biashara Club, that among other activities offers workshops on entrepreneurship and capacity building, networking possibilities, and business advisory services through SME Management seminars and workshops on a variety of relevant topics. Since the launch, the Bank has on-lent over USD \$1.6 million to 350 women entrepreneurs

Ensuring that the regulatory framework for credit reference agencies enables women to establish their own credit history, separate from their husbands, is another area of good practice. Analysis and reform programs should consider whether laws on credit information treat women, regardless of marital status, in the same way as men; whether the credit history can be established and captured through participation in microfinance or group lending schemes; and the extent to which a married person's assets considered to be consolidated with his or her spouse's assets for the purposes of the credit history.

In addition to ensuring that women have equal capacity by law, facilitating the use of movable assets as collateral, guaranteeing that women can build their credit histories, and prohibiting gender discrimination in relation to credit applications, another consideration is a realistic and sustainable enforcement mechanism. There is growing evidence that restricted access to commercial justice can represent a significant barrier for women. Women's basic commercial rights, such as property ownership, can be unclear and uncertain, and women can face barriers and discrimination when they seek to uphold their commercial rights through the courts. As such, alternative dispute resolution (ADR) mechanisms that are designed in an inclusive way so that the existing gender inequities are not perpetuated may have a positive effect on women's ability to enforce their contractual rights.

Challenges and Priorities for LDCs

Many women entrepreneurs face higher and differentiated barriers such as gender-discriminating laws and customary practices, while also having less access to resources, and lower levels of education, training, and work experience. In addition, they often face restrictions on mobility and generally have more demands on their time. Women continue to be concentrated in small, low-growth firms, and a disproportionate share of women's businesses fail to mature. This has negative

implications for growth and poverty reduction in developing countries. Understanding the barriers women's businesses face and providing solutions to address them is necessary if countries hope to further leverage the economic power of women for growth and the attainment of development goals. Further, lack of access to land title can be a major impediment for both men and women. For instance, more than 85 percent of loans in Kenya require collateral, and the average value of the collateral taken is nearly twice that of the loan. In the vast majority of cases, the collateral required is land, usually land that has a registered title. Women hold only 1 percent of registered land titles, with about 6 percent of registered titles held in joint names.⁸⁷ In this respect, reforms of a country's secured lending system to enhance the use of movable securities can have a significant impact on access to credit across the board. Enabling movable assets—such as machinery, book debts, jewelry, and other household objects—to be used as collateral can benefit all businesses. But opening up this type of financing has the potential to be of particular benefit to land-poor women, enabling them to circumvent their lack of titled land and use the assets they do have to unlock access to formal credit markets.⁸⁸

C.5: Agrifinance for SMEs

There is now a broad consensus for more agricultural investments in order to increase food production and combat poverty. However, there are no quick political fixes, and the provision of sustainable financial services for agriculture has proven to be difficult. The past years have proven that neither commercial banks nor the emerging microfinance industry alone can sufficiently meet the financial needs along agricultural value chains. Many farmers and agrifinance SMEs are left unserved and trapped in the so-called “missing middle” between micro- and commercial finance. The old paradigm has failed to achieve the desired effects, as top-down government interventions to correct market failures

87 World Bank, Kenya Investment Climate Survey, 2004.

88 For more discussion on this topic see Simavi et al, Gender Dimensions of Investment Climate Reform, A Guide For Policy makers and Practitioners, Module 5, Secured lending, World Bank 2010.

frequently led to government failures. Hence, a new market-based approach emerged, which shifted its emphasis from allocating cheap capital to creating sustainable agricultural financial systems. In this new approach, credit subsidies are reduced in favor of market-based loans and technical assistance, in order to design appropriate products, institutions, and policies.

Standards, Best Practices, and Examples

Throughout the last decades, clear principles have emerged from experience with agricultural finance subsidies, and research on the use of these subsidies has resulted in guidelines for “smart” or “market-friendly” subsidies. These guidelines include the following:

- Any subsidy should be temporary and transparent.
- Subsidies should be targeted toward institution building and not the borrowers (i.e., interest rate subsidies), in order to reduce market distortions.
- Subsidies should not undermine competition by favoring specific institutions. Financial institutions should be subsidized where there is natural spillover to non-subsidized institutions.
- Subsidies should be used for the creation of public goods that benefit the entire financial sector.
- The most effective subsidies are smart subsidies for capacity building mechanisms and activities in the context of innovative financial instruments such as value chain finance, credit guarantee funds, and warehouse receipts.

A major building block to bring forward agricultural finance is capacity building for both the rural communities and the rural financial institutions. In order for farmers and agricultural SMEs to become more bankable, and to become attractive business partners for banks and trading partners, the following steps are useful:

- Provision of training and extension services in good agricultural practices (i.e., knowledge of how to be a good farmer) and market orientation;
- Provision of training in basic farm economics and adoption of a business approach to farming (i.e., knowing how to make a business from farming);

- Financial literacy and financial management training (i.e., how to access external financing sources and what it takes to become bankable); and
- A certain degree of organization both at the same level (e.g., farmer-based organizations, machinery rings or cooperatives) and between actors at different levels of value chains (e.g., contract farming schemes) in order to facilitate information flows, realize economies of scale, and gain bargaining power.

Rural finance capacity building includes staff training, data collection, reform of financial institutions’ governance structures, and implementation of adequate risk management tools for both commercial banks and non-bank financial institutions. The challenge is to successfully apply financial techniques to the agricultural sector.

Commercial banks usually lack agricultural knowledge; it is rare to find a combination of a banker and an SME agri-specialist. There are two primary ways to build agricultural capacities in banks. The first way is to build institutional capacities, through extensive knowledge transfer and staff training, with the goal of developing and implementing the specific risk management tools, credit processes, sales channels, and product development that are required for adequate agricultural lending. The second option is to establish linkages between supply chains and banks, and identify suitable service providers to assist agricultural SMEs in preparing business plans and loan applications, thus allowing them to access banking services. In the end, there could be some delivery of basic extension services to farmers through various intermediaries, ultimately linking them back to the bank.

After years of reforms, specific agricultural banks, especially in Asia, have achieved financial sustainability and significant outreach. Among the most remarkable success stories are Bank for Agriculture and Agricultural Cooperatives in Thailand and Land Bank in the Philippines⁸⁹. Development banks shifted from purely focusing on agricultural toward a balanced multi-sector approach that included strict commercialization,

89 See http://www.baac.or.th/baac_en/index.php, and <https://www.landbank.com/> respectively.

domestic resource mobilization, and cost-covering operations. Successfully reformed development banks might offer a real opportunity for agricultural SMEs. Different approaches to reforming public banks can be viable and their success depends to a significant extent on specific country conditions. Keys for success include a strong political will and a coalition to manage and bring forward the transformation.

Several innovations have been introduced to enhance rural outreach by reducing transaction costs and avoiding high fixed costs of maintaining branches. Examples include mobile phone banking, automated teller machines, and points-of-sale devices. The basic idea is that information and communication technologies boost access to finance by radically reducing transaction costs in rural areas. The most prominent example is the service M-Pesa, provided by the mobile network operator Safaricom in Kenya, which has developed into one of the largest banks in all of eastern Africa⁹⁰. However, the drawback with these innovations is that they are new. In most countries, there is no existing legislation for mobile phone and agent-based banking. Regulators should thus carefully weigh the potential risks and benefits in order to allow agents to function as an interface between banks and customer.

Another innovative instrument is **value chain finance**. Internal value chain finance has several advantages over conventional agricultural finance:

- Value chain actors tend to have better knowledge of the key risk and profitability factors in a particular sub-sector;
- The bundling of finance with other services, such as input supply, extension services and off-take contracts, reduces credit risks;
- Tying credit with commodity flows can reduce transaction costs of lending; and
- Since agribusiness companies tend to provide input credit for reasons other than financial intermediation, they may tolerate higher levels of loan default than financial institutions.

Generally, the value chain finance approach of pre-financing production works best in situations with limited competition between buyers. In a liberalized market environment, this mainly applies to niche market products, products with a single use (i.e., banana), and bulky or highly perishable products that require immediate processing (i.e., sugarcane).

The major challenge of value chain finance arrangements, internal and external, lies in their high set-up

AGRICULTURAL LEASING: BANCO DE LAGE LANDEN BRASIL

De Lage Landen (DLL), an international provider of leasing and asset finance, has built up an agricultural finance portfolio in Brazil that is nearing \$3 billion. This portfolio has been almost completely generated in partnership with agricultural equipment vendors. Through BNDES, Brazil's national development bank, banks and financial institutions can provide finance to the agricultural sector at subsidized rates. DLL has distributed more funds than the general banks to the agricultural sector. Key for De Lage Landen's approach are: first, a deep understanding of farming and of the agricultural value chain in Brazil; second, a thorough knowledge of agricultural equipment, control over its distribution chain; and, knowledge of the collateral value of the equipment and how to remarket it if needed. Most leases have a downpayment or another form of clients' equity in the transaction and a cash-collateralized partial guarantee from the dealer. Brazilian farmers want to own their equipment and prefer loans over leasing.

Source: G20 Policy Paper on Agricultural Finance for Small and Medium Sized Enterprises

90 See <http://www.safaricom.co.ke/index.php?id=250>

costs, given that the financing structure and related contractual arrangements and procedures for monitoring and enforcement need to be tailored to a specific situation. Moreover, many financial institutions lack sufficient knowledge about value chain financing techniques and the skills to apply them.

Leasing offers the potential to reduce some of the risks of traditional loan provision for investment financing in agriculture. Leasing can provide an alternative financing solution for smallholder farmers and rural enterprises with limited collateral and credit history for the acquisition of equipment and other production assets. It helps to circumvent some of the problems related to the registration and foreclosure of collateral and can be used for financing machinery and movable assets such as vehicles and farm equipment. Since the lessor owns the equipment, repossession in case of default is more straightforward as it does not require court procedures. Leaseback enables rural entrepreneurs to access funds by selling a productive asset to the lessor, who then leases it back to the lessee. At the end of the stipulated period, the lessor sells the asset back to the lessee at a pre-determined price. The use of leasing and leaseback is greatly facilitated by a suitable legal framework stipulating the rights and obligations of both parties. However, tax regulations can make leasing less lucrative than lending. Despite the advantages of leasing in principle, few institutions offer equipment leasing and leaseback to rural customers.

A further policy instrument to stimulate medium- and long-term agrifinance lending can be agricultural guarantee funds. Guarantees may provide additional comfort for financial institutions interested in testing the feasibility of lending to a new clientele, but a guarantee alone is unlikely to induce additional lending if the lenders lack such interest. International agencies can perform a valuable service by conducting evaluations to determine if and under what conditions guarantees produce the expected results and how the details of guarantee designs affect performance. It is also critical to evaluate whether they distort markets and discourage private credit market development.

Index-based crop insurance shows promise in overcoming some of the risk related constraints. Indemnity payments are triggered by deviations from an independently verifiable indicator such as rainfall data measured at local weather stations, and not by on-site loss assessments. Weather-index insurance thus offers the promise of reducing the administrative, adverse selection, and moral hazard problems of traditional insurance. Different indices can be used, such as rainfall, temperature, or livestock mortality, as long as they are highly correlated with regional farm yields and are accurately and objectively measurable. However, weather index based insurance has its own operational challenges. Not all pilot programs have been successful and the scalability of the successful pilots has not yet been proven.

Challenges and priorities for LDCs

The challenges of providing financial services to agricultural enterprises are wide ranging, and can be more severe in LDC rural sectors. The dispersed location of rural clients, the difficulties and high costs of transportation and communication, the heterogeneity in farming activities, and the level of management skills make small farm lending a costly endeavour. The high agricultural production risks, further complicated by the sensitive political nature of agriculture and domestic food production, explain why lending to agriculture is risky. All of these challenges are present at different levels of the financial system, the policy level, the financial infrastructure level, and the level of financial institutions.

Financing agricultural SMEs requires both SME finance and knowledge about the agricultural sector. However, in many LDCs, financial institutions know very little about agriculture and lack the specific agricultural risk management skills, suitable products, and term liabilities to finance agricultural SMEs. On the demand side, agricultural SMEs frequently lack the required financial data, business plans, marketing tools, and sufficiently powerful projects to convince financial institutions to provide adequate funding.

A functioning financial infrastructure reduces the information asymmetries and legal uncertainties that increase risk to SMEs and constrain the supply of finance. However, the LDCs agricultural sector suffers from the lack of a solid financial infrastructure, including auditing and accounting standards, credit registries/bureaus, collateral, insolvency regimes, and apex institutions. A weak financial infrastructure is a huge challenge for SMEs, as tracking financial information builds a credit history and functioning collateral regimes reduce adverse selection and moral hazard. Missing financial data and standards form a severe roadblock for access to SME finance.

Moreover, the range of available loan products in the LDCs agricultural sector is very limited and tends to by-pass the real needs of agricultural SMEs. Prevailing loans structures are short term, with inflexible repayment schemes and traditional collateral

requirement. However, agricultural activities are subject to seasonality and long gestation periods, resulting in infrequent cash flows and long-term financing needs. Slow rotation of capital results in a lower profitability of agriculture and related activities when compared to other sectors, such as trade and services, with a quick turnover of funds. Hence, lenders need to offer longer loan maturities and less frequent repayment installments in order to match the cash flow of borrowers. This requires more than just strong appraisal skills and efficient loan monitoring and borrower supervision to manage credit risk. Lenders also need to mobilize sufficient long-term funding sources in order to minimize asset liability mismatches and the associated risks. On top of specific funding needs, SMEs in the agricultural sector need adequate risk reducing mechanisms in order to cope with covariant risks related to weather events or price fluctuations.

CHAPTER D

Recommendations

Polymakers should design policy measures, legal reforms, financial infrastructure improvements, and interventions on the basis of diagnostics and data. An in-depth understanding of SME Finance constraints is necessary to allow prioritization and sequencing, so that the most binding constraints are addressed first, and so that regulatory and implementation capacity is not overstretched. Financial inclusion strategies and country action plans can provide the context for effective measures to promote SME finance, and for coordination and sequencing with other reforms and initiatives.

D.1. Regulatory and Supervisory Frameworks

ROLE OF REGULATORS

The G-20 Report on Financial Inclusion highlights the importance of government and regulatory leadership in efforts to promote financial inclusion. In the case of regulators, this can be through:

- A proactive approach to addressing regulatory issues that constrain SME access to finance, possibly through financial inclusion strategies or commitments;
- Openness to considering innovation;
- Enforcement of consumer protection measures;
- Careful attention paid to proportionality in measures to maintain the safety and soundness of their financial systems; and
- Effective monitoring and supervision of expanding SME finance provision, based on improved data and capacity.

Recommendations set out in the draft GPFI paper “Global Standard Setting Bodies and Financial Inclusion for the Poor: Towards Proportionate Standards and

Guidance” provide a reference point for country-level regulators. These recommendations note that gradual and tailored implementation of standards is appropriate, given LDC regulators’ limited capacity and resources. The G-20 Principles for Innovative Financial Inclusion also highlight the importance of proportionality: “Build a policy and regulatory framework that is proportionate with the risks and benefits involved in such innovative products and services and is based on an understanding of the gaps and barriers in existing regulation.” Legal requirements should be correlated with the differing levels and types of risk involved in different activities. Regulations should enable, rather than inhibit, appropriate innovation in connection with regulated activities, in a way that manages risk.

BASEL II/III AND SME FINANCE

Recommendations regarding the implementation of Basel II in LDCs, with particular reference to the effects on SME development, include:

- LDC regulators should proceed cautiously in implementing Basel II. Political support may be needed so that LDCs do not rush to implement the more complex approaches favored by international banks.
- LDC regulators need to carefully assess the implications of Basel II, for banking stability, for credit policy, for access to credit for SMEs, and on competitiveness of national versus international banks.

Capacity problems, issues related to consolidated supervision, independence of the supervisor, and legal protection for supervisors, should be addressed. Basel III reinforces the quantity and quality of capital requirements that were introduced under Basel II. It is not clear whether or to what extent SMEs would be

more adversely affected than other clients (consumers, large corporates) by Basel III, and an objective evaluation of the potential impacts may be merited. The gradual implementation of the new Basel III rules (which are to be fully adhered to by 2019) gives banks time to adjust to the new capital requirements.

ENABLING REGULATORY FRAMEWORKS FOR ALTERNATIVE SME FINANCE PRODUCTS: LEASING, FACTORING

Factoring is an important source of working capital finance for SMEs, and leasing is an important source of investment finance for SMEs, especially in jurisdictions where the financial infrastructure is deficient.

A legislative framework for leasing should: i) clarify rights and responsibilities of the parties to a lease; ii) remove contradictions within the existing legislation; iii) create non-judicial repossession mechanisms; iv) ensure that tax rules are clear and neutral, removing any bias against leasing; and v) clarify the rights of lessors and lessees under bankruptcy.

The laws governing contracts between parties and assignment of receivables are most directly relevant to factoring. Where these laws are clear and enforceable, factoring has developed without any specific legal or regulatory framework for factoring as such. A major area for decision in a regulatory framework for factoring is determining the criteria for the entities who will be allowed to perform factoring activities.

COMPETITION

Competition can be a powerful incentive for financial players to develop their SME business. Based on best practices around the world, competition can be promoted through the following measures:

- Financial sector liberalization and banking regulations that allow the entry of sound and efficient banks and other types of financial providers;
- A legal and regulatory framework that promotes the development of alternative lending technologies such as leasing and factoring, as well as the development of securities markets and institutional investors as an alternative to bank lending;
- An antitrust authority that oversees decisions pertaining to mergers and acquisitions and weighs the pros and cons of these transactions;
- A competition authority that is ready to act against potential cartels influencing the pricing of bank products;
- Greater transparency and more information dissemination about the pricing and conditions of bank products, in order to empower borrowers to make good decisions and to “shop for the best deal.” Financial literacy could also help borrowers make better decisions and would pressure banks to offer more suitable products.
- A consumer protection agency that watches out for evidence of anticompetitive behavior of banks and takes the matter up with the competition authority;
- Efforts to improve the scope, access, and quality of credit information among banks, which would level the playing field between large and small banks (including new foreign banks) and allow these banks to expand more rapidly; and
- Complementary prudential regulation, and coherence between competition policy and regulation in the financial sector, to minimize any potential destabilizing effects from increases in competition.

LDC policymakers often have only a limited range of effective tools and capacity, however, to set up or enforce competition measures, such as a competition authority. In the interim, bank supervisors could be given a clear mandate to promote sound competition in the banking sector. For example: i) bank regulators should give greater weight to sound competition when implementing licensing criteria; and ii) strengthening the credit concentration regime may also contribute to increased competition translating into access gains⁹¹ (the latter could be achieved by

supervisors applying stricter limits (on an individual or portfolio basis) or imposing additional capital requirements for banks with higher credit concentrations (consistent with risk).

D.2 Financial Infrastructure

SECURED TRANSACTIONS

To create a modern secured transactions system for SME Finance, in line with internationally accepted standards, emphasis should be placed on the following:

- *Creating unitary legal secured transaction systems vs. fragmented laws.* Creating or drafting a standalone law to regulate all aspects of security interests in movable property (secured transactions or personal property law) is considerably more efficient and creates less conflicts and uncertainty than revising existing provisions in multiple laws (commercial code, civil code, chattel mortgage law, etc.).
- *Promoting a broad scope in the secured transactions law.* States should aim at enacting secured transactions laws that are comprehensive in scope to provide equal treatment to all forms of secured transactions (loans, leases, assignment of receivables, consignments, retention of title, trusts, etc.), to include all categories of debtors (both natural and legal persons) and secured creditors, and to allow all types of movable assets (tangible, intangible, present or future) and secured obligations.
- *Modernizing movable collateral registries.* The collateral registry is the cornerstone of a functioning and efficient secured transactions system. The registry fulfills an essential function of the system, which is to notify parties about the existence of a security interest in movable property (of existing liens) and to establish the priority of creditors vis a vis third parties.
- *Establishing clear priority schemes for creditors.* A clear priority scheme is key to determining the sequence in which competing claims to the collateral will be satisfied when the debtor defaults on one or more of the claims.

- *Improving enforcement mechanisms.* Enforcement and collection of debts upon defaulted loans is a major impediment for increasing access to credit. Speedy, effective, and inexpensive enforcement mechanisms are essential to realizing security interests. Enforcement is most effective when parties can agree on rights and remedies upon default, including seizure and sale of the collateral outside the judicial process.
- *Creating awareness and educating stakeholders.* Development of training and capacity building programs targeting public sector (government officials and judiciary) and private sector (financial sector, business community, lawyers) is essential.

INSOLVENCY REGIMES

Stronger creditor rights can improve access to finance. Bankruptcy regimes regulate the efficient exiting of the market, and make the resolution of multiple creditors' conflicting claims more orderly, resulting in more extensive opportunities for recovery. Relevant principles of insolvency include:

- A legal framework to address the insolvency of all business entities, regardless of their legal form;
- Simple procedures to open a case and sell assets;
- Fast-track proceedings for small enterprises with low debt values;
- The ability of small businesses to propose restructuring plans to their creditors;
- The use of mediation or other alternative dispute resolution tools to facilitate negotiations between debtors and creditors;
- Provisions for courts to recognize out of court settlements;
- Quick conversion to liquidation for failed reorganizations;
- Decriminalization of bankruptcy;
- Enhanced capacity for, and oversight of, insolvency administrators; and
- A balanced approach between reorganization and liquidation.

CREDIT INFORMATION SYSTEMS

Governments and public authorities have a critical role to play in developing an efficient, safe, and reliable credit reporting system that covers both identification and relevant credit information on both individuals and businesses. The result is a system that can seamlessly cover micro-, small, and medium-sized businesses and thus help lenders better manage credit risk and extend access to credit. An effective oversight by the central bank or other relevant authorities contributes to addressing failures in the functioning of credit reporting systems.

Steps to develop credit information systems may involve the promotion of the following, in line with the World Bank credit reporting standards:

- Establishment of a clear, proportionate, non-discriminatory legal framework supportive of consumer rights;
- Establishment of an effective oversight of credit reporting systems identifying a primary overseer and coordinating efforts among all relevant authorities;
- Ensuring that relevant and sufficient information is included in the credit reporting systems as well as appropriately used;
- Provision of data electronically and in real time;
- Rapid updating and processing of credit report information (positive as well as negative); and
- Provision of additional services such as credit scores by credit reporting service providers.

PAYMENT SYSTEMS

The Committee on Payments and Settlement Systems (CPSS) has identified a set of overall strategic goals and objectives for retail payment systems, based on the key public policy objectives of efficiency and reliability. The following actions should be considered to support SME finance:

- Extend availability and choice of electronic payment instruments and services;
- Promote broad-based and affordable access to electronic payment instruments;

- Increase competition between providers of payment services;
- Increase cooperation between providers and develop mechanisms for market coordination;
- Strengthen oversight of retail payment systems;
- Promote the use of technology;
- Improve transparency and financial literacy among SMEs;
- Strengthen cross-border payment systems; and
- Remove policy, legal, regulatory, and administrative impediments to the expansion and development of payment system technologies.

EQUITY INVESTMENT

Increasing SME access to equity markets can involve a range of interventions, including: i) improvements in disclosure and governance; ii) improvements in minority shareholder protection; and iii) a stronger domestic institutional investor base and greater participation of foreign investors, which may require the relaxation of limits on foreign ownership of listed companies in some countries. Setting up SME stock exchanges or junior markets can under certain circumstances further improve the supply of equity investment to SMEs, with the following pre-requisites:

- The underlying legal and capital market regulatory frameworks are reasonably well-developed, robust and, above all, trusted by investors;
- Access to credible corporate information on SMEs is widely and readily available;
- A reasonably broad spectrum of early-stage equity capital is available from angel, venture capital, and private equity investors; and
- The size of both the private sector and the qualified institutional investor community is sufficiently large to support the growth of the market generally.

Public or development finance to catalyze or provide equity-type financing for innovative and high potential SMEs can be needed in the interim to compensate for the lack of available VC financing and access to equity markets for many such SMEs in LDCs.

ACCOUNTING AND AUDITING STANDARDS FOR SMES

The lack of transparency of SME accounting and financial statements makes them risky borrowers and thus less attractive to lenders. Capacity building of SMEs in terms of preparing financial statements and business plans, as well as improving their financial literacy and management training, may have a positive impact on SME development. Care should be taken in applying rigid and potentially harmful reporting standards to smaller enterprises, which could be counter-productive.

A clear case can be made in favor of simplified accounting and financial reporting framework for smaller enterprises, with requirements commensurate with their size, the types of transactions they conduct, and their limited range of stakeholders. A “one-size-fits-all” approach to financial reporting and auditing requirements ignores the capacity constraints that SMEs face and unnecessarily increases the cost of doing business for those enterprises, which generally drive economic growth. In addition, by increasing the requirements for SMEs, governments may create disincentives for businesses to operate in the formal sector. A holistic approach would take into account SMEs’ need for relief from excessive accounting and auditing requirements, as well as their need for more time to implement appropriate standards effectively.

While increased transparency for SMEs is central to improving access to bank financing, improved financial infrastructure (for example, credit information systems) can be effective in improving transparency. Rigidly applying IFRS in LDCs, including even the tailored “IFRS for SMEs,” could reduce rather than promote economic activity by these enterprises, and have negative implications for growth.

D.3 Public Sector Interventions

Governments can address market failures and incomplete markets that inhibit the provision of adequate financing for SMEs. Government measures to promote SMEs should be carefully focused, aiming at making markets work efficiently and at providing incentives for the private sector to assume an active role in SME finance. LDC governments are relatively more fiscally and capacity constrained, and the potential for direct public sector interventions is more limited, without donor assistance.

STATE BANKS

For state-owned banks to play a positive and complementary role in the provision of credit to SMEs, the following have proven to be pre-requisites:

- Legislation specifying clear mandates (to deflect political interference);
- Sound governance structures with independent boards;
- Clear performance criteria;
- The obligation to price loans according to risk, and to generate a positive return; and
- The ability to recruit and retain qualified staff.

APEXES AND OTHER WHOLESALF FUNDING FACILITIES

Second-tier funding facilities, or apexes, can be set up to manage and on-lend funds to financial institutions, and to accelerate the growth of sound SME retail capacity in order to expand access to finance. Preconditions for successful application of this model include:

- Define the apex mission and objectives clearly with a focus on building strong, sustainable, and responsible financial institutions and SMEs, not loan disbursements and outreach.
- Focus on putting in place good governance, capable management, and an appropriate organizational

structure at the outset. The most effective apexes are those that are politically independent, with professional, effective boards and capable management.

- Select the right institutions. Apexes need robust selection criteria and appraisal procedures and should focus not on the number of the financial institutions they fund, but rather the quality of those institutions.
- Design the mission and instruments to fit with the market context. Apex loans should be tailored to the cash flow patterns and planning needs of financial institutions. In more mature markets, apexes might want to consider broadening their range of products to include quasi-equity, equity, or guarantees.
- Manage an apex portfolio based on performance. To ensure good performance, apexes need to have good quality data on financial institution portfolios, review their progress on a regular basis, and be willing to act in the case of poor performance.
- Provide adequate support for building the staff capacity of the apex itself. At an early stage of its development, funders of apexes (including governments) should ensure that the apex has the right team in place and is receiving technical support to build its own staff capacity.
- Encourage apexes to crowd in commercial local funding by having this as one of their objectives. Funders of apexes, including governments, should encourage apexes to collaborate and share information with local banks and international commercial lenders.⁹²

PARTIAL CREDIT GUARANTEE SCHEMES

Credit guarantee schemes are considered one of the more market-friendly types of interventions, as they can generate fewer distortions in the credit market than state banks and other direct public interventions, and may lead to better credit allocation. Key features of a well-designed scheme include:

- **Eligibility criteria:** Guarantee schemes should target SMEs through ceilings on turnover, number of

employees, and/or size of the loan. Restrictions on sectors or types of loans should generally be avoided.

- **Approval rules and procedures:** Final approval or rejection of an application should occur within two weeks.
- **Coverage ratios:** Coverage ratios should ensure sufficient protection against default risk while maintaining strong incentives for effective loan origination and monitoring.
- **Fees:** Fees should be risk-based and contribute to the financial sustainability of the scheme.
- **Payment rules and procedures:** Payment rules should take into account the effectiveness of the collateral and insolvency regimes. Schemes in LDCs should base payments on default events while ensuring incentives for effective debt collection.
- **Capacity building:** PCGs can support the capacity of banks to provide SME finance and good practices.
- **Evaluation mechanism:** Such a mechanism is necessary to measure outreach, additionality, and sustainability.
- **Supervision:** Oversight is a key element to ensuring the soundness of operations.
- **Risk weighting for banks' prudential requirements:** A well designed and financially robust guarantee scheme should allow regulators to assign a lower risk weight to exposures covered by the guarantee.

GOVERNMENT PROCUREMENT FROM SMES

The public sector can be a major buyer of goods and services from SMEs, and can more effectively link SMEs to supply chain finance and to factoring through that contractual and payment relationship. Electronic security and signature laws, and market facilitation platforms, can facilitate supply chain and factoring transactions with SMEs.

It is also critical that governments pay SMEs promptly, in order to avoid otherwise viable SMEs incurring cash flow problems that can cause them to scale back or even close business activity.

92 Extracted from Forster, Sarah and Duflos, Eric - "Re-assessing the Role of Apexes: Findings and Lessons Learned", Forthcoming, CGAP, 2011.

SME CAPACITY, CREDITWORTHINESS

Recommendations for public sector-supported initiatives to improve SME capacity and creditworthiness include:

- Successful capacity building involves finding the right balance between adaptation and standardization of training content and delivery methods. The donor or development institution can ensure that the training is standardized enough to allow for scalability and consistent evaluation, while local trainers increase the effectiveness of training by tailoring it to the needs of specific segments (e.g., women entrepreneurs) and business contexts (e.g., conflict-affected areas).
- It is more effective for donors or development institutions to help build the capacity of local training firms than it is to provide direct training to SMEs. Such a “wholesale” approach allows the intervention to achieve scale more effectively, can create commercially-viable local businesses, and creates incentives for the development of training approaches adapted to the audience and local environment.
- Both public and private organizations have a role to play in capacity building. Public-private partnerships are one way to ensure that capacity-development services are delivered by private actors, while still meeting broader societal objectives. It is also possible to provide training on a commercial or semi-commercial basis. The key to effective commercialization is to find a market gap for tailored interventions that meet the needs of clients.
- Benchmarking and program evaluation pose challenges to SME support providers, yet ongoing monitoring and evaluation is critical to the effective use of interventions. Evaluation should consider client impact, institutional or partner performance, and market development.

D4: Women and SME Finance

The GPFi Women in Finance workstream covers SME finance. Relevant recommendations include:

- Structure country diagnostics of demand and supply for SME finance to uncover gender gaps, drivers of access to finance for women, and the need for any tailored policy responses.
- Build reliable gender-disaggregated data sources on women’s businesses and access to finance.
- Develop a supportive legal and regulatory environment framework. Increasing women’s legal access to property improves access to collateral and control over financial services.
- Strengthen the financial infrastructure. Expand financial infrastructure elements such as credit bureaus and collateral registries that can increase access for women and reduce the costs of borrowing.
- Design effective government support mechanisms. Policymakers should review existing activities and programs on financial inclusion to ensure they include gender issues.
- Consider appointing a national leader/champion for women-owned SMEs, someone who can coordinate with different stakeholders and ensure the agenda is a priority.
- Consider incentives and specific goals for increased procurement by governments of goods and services from women-owned SMEs.
- Build the capacity of financial institutions to better serve women entrepreneurs. Expand research into effective ways to combine access to finance and business training.

D.5: Agrifinance and SMEs

SMEs are significant actors in agricultural value chains, including in processing, distribution, and marketing activities. The parallel GPFi Agrifinance work agenda provides the following relevant recommendations:

- Include the agribusiness sector in diagnostics of demand and supply for SME finance.
- Strengthen contract enforcement, to support the contract rights for creditors, farmers, and SMEs that underpin value chain structures and facilitate finance to all market participants.
- Ensure that financial infrastructure is also relevant to agrifinance, for example that credit bureaus include value chain finance providers, that land tenure and land rights issues are addressed, and that agricultural equipment can be used as collateral through asset registries.
- Coordinate policies intersecting both the financial and agriculture sectors, which is critical to facilitate access to finance for farmers and agricultural SMEs.
- Governments should invest in the regular collection and dissemination of reliable data related to agricultural finance, including to underpin index-based insurance.
- Support capacity building – which is necessary to enhance the capabilities of staff in financial institutions to serve agricultural clients – and the financial literacy and management skills of agricultural SMEs and farmers.

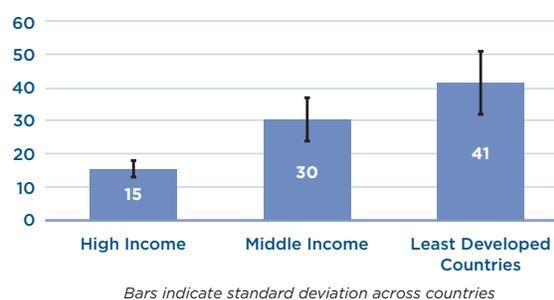
ANNEX I

Access to Finance for SMEs in LDCs

Access to finance remains a key constraint to SMEs development especially in emerging economies.⁹³ For example, data from World Bank Enterprise Surveys indicate that access to finance is disproportionately difficult for SMEs in Least Developed Countries (LDCs). As shown in Figure 1, 41 percent of SMEs in LDCs report access to finance as a major constraint to their growth and development, compared with 30 percent in middle-income countries (MICs) and only 15 percent in high-income countries.⁹⁴

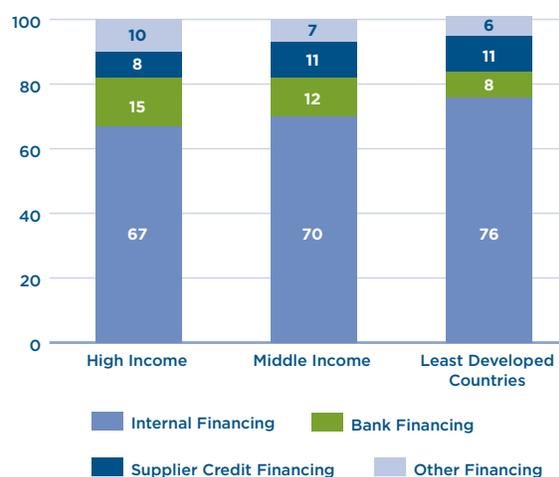
SMEs in their early stages of development rely on internal sources of funding, including the owner's personal savings, retained earnings, or funding through the sale of assets. As firms start expanding, external sources become more important and their availability can determine the firms' growth possibilities. External finance is positively and significantly associated with productivity and conversely, while financing from internal funds, and other informal sources, is typically negatively associated with growth and firm performance.⁹⁵ Figures 2 and 3 show how SMEs use different financing sources for working capital and fixed investments by country income groups. LDC SMEs show a higher dependence of internal financing compared with SMEs in more developed countries. Their use of bank financing⁹⁶ is significantly lower than high- and medium-income groups. Supplier credit, an arrangement between two businesses that allows delaying payment for the goods and services purchased, seems to be a substitute for bank financing to meet short-term working capital needs.

FIGURE 1 ACCESS/COST OF FINANCE AS A MAJOR CONSTRAINT



Source: World Bank Enterprise Surveys, 2006-2009

FIGURE 2 SME WORKING CAPITAL: FINANCING SOURCES



Source: World Bank Enterprise Surveys

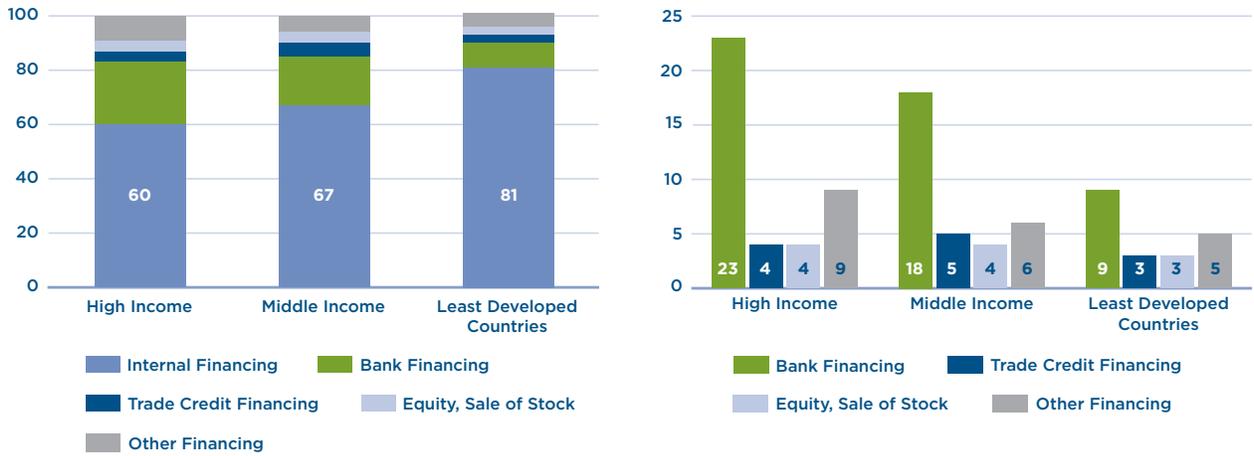
93 See Beck, Demirgüç-Kunt and Maksimovic (2005)

94 Numbers by income group are simple averages of all countries, with data available, that fall in the group.

95 Beck, Demirgüç-Kunt, and Levine. (2005)

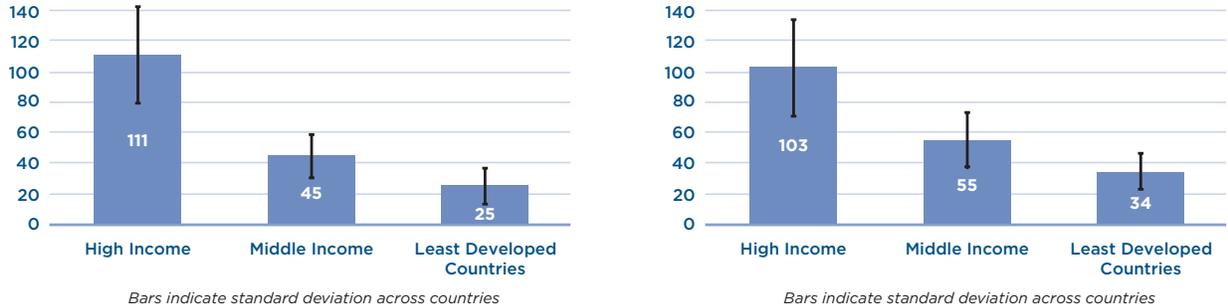
96 See Beck, Demirgüç-Kunt and Maksimovic (2008)

FIGURE 3 SME FIXED INVESTMENTS: FINANCING SOURCES



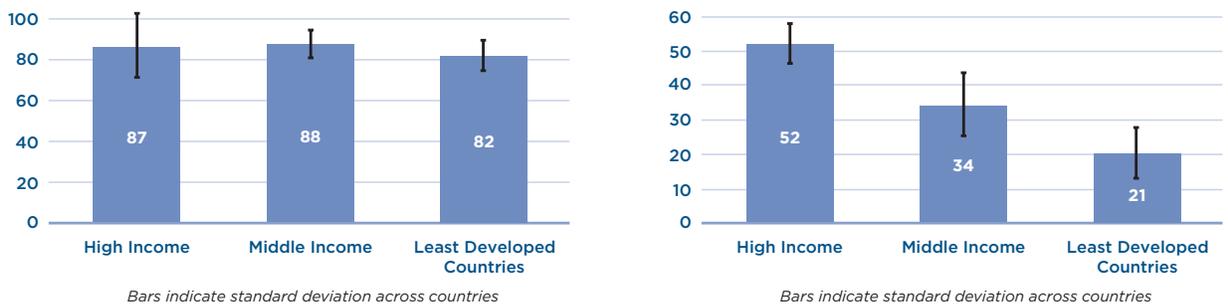
Source: World Bank Enterprise Surveys

FIGURE 4 FINANCIAL DEPTH INDICATORS

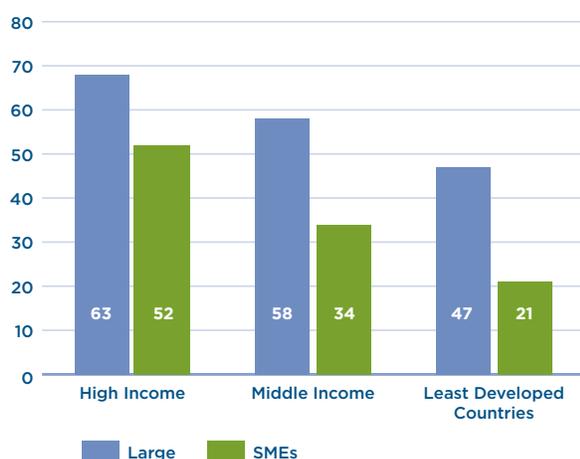


Source: World Development Indicators

FIGURE 5 SME BANKING RELATIONSHIP



Source: World Bank Enterprise Surveys, 2006-2009

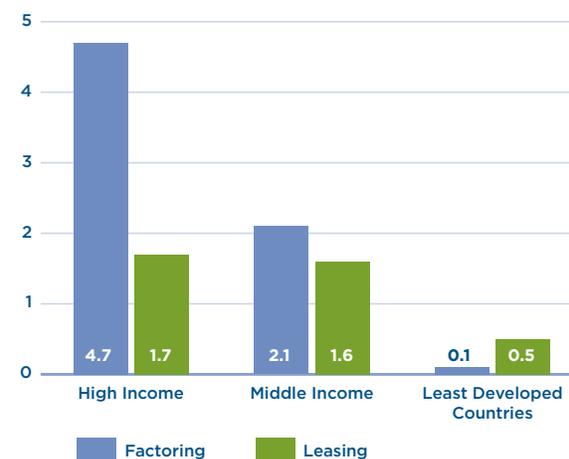
FIGURE 6 PERCENTAGE OF FIRMS WITH BANK LOANS/LINE OF CREDIT

Source: World Bank Enterprise Surveys, 2006-2009

The SMEs financing pattern in LDCs can be explained by both access to finance constraints and deficiencies in the enabling environment. Traditional indicators of financial depth, such as private credit and bank deposits to GDP, indicate that LDCs have a lower level of financial services compared with more developed countries.

Although the percentage of SMEs with a banking relationship via deposit/checking accounts is similar for different income groups, access to credit is significantly lower in LDCs. As shown in Figure 5, only 21 percent of SMEs in LDC have access to a bank loan, while the percentage with access is 34 percent in middle-income countries and 52 percent in high-income countries.

Access to finance through bank loans not only decreases with the level of development but also tends to be concentrated among large borrowers. While commercial banks in developed countries have become better able

FIGURE 7 LEASING AND FACTORING AS PERCENTAGE OF GDP

Source: White Clarke Global Leasing Report, Factors Chain International

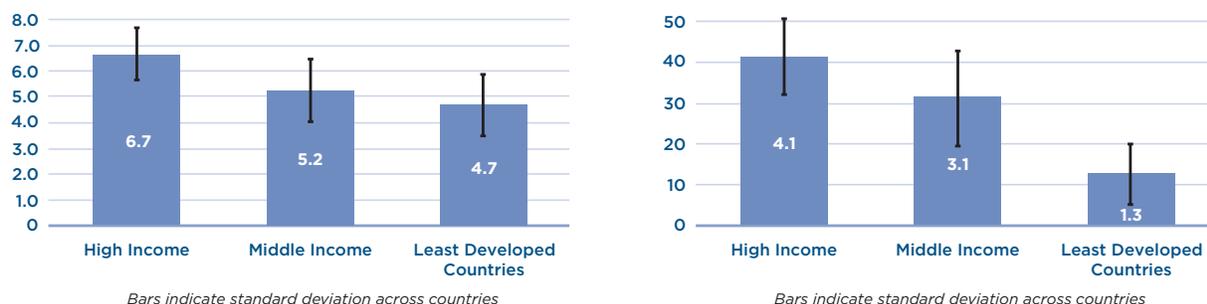
to serve the needs of SMEs, banks in developing countries are often still constrained in their interest and ability to expand SME lending. As Figure 6 shows, the concentration in terms of outreach is higher in LDCs than other income regions. In LDCs, only 21 percent of SMEs have a bank loan or line of credit.⁹⁷

Other common sources of finance for SMEs include leasing and factoring. However, as Figure 7 shows, they are not yet well developed in LDCs.

Equity financing is an important potential source of financing for SMEs, particularly in their early stages when cash flow is not yet regular. While some countries have established dedicated market segments or separate trading platforms exclusively for the SME sector, the performance, particularly in the lower-income countries, has been unimpressive. For the majority of SMEs in emerging markets, access to local or international capital markets is not yet available.⁹⁸

97 Results are in line with studies showing SME loans as a percentage of total bank loans decreasing in developing countries. See Beck, Demirgüç-Kunt and Martínez Peria (2008)

98 OECD (2006)

FIGURE 8 STRENGTH OF LEGAL RIGHTS AND CREDIT INFORMATION INFRASTRUCTURE

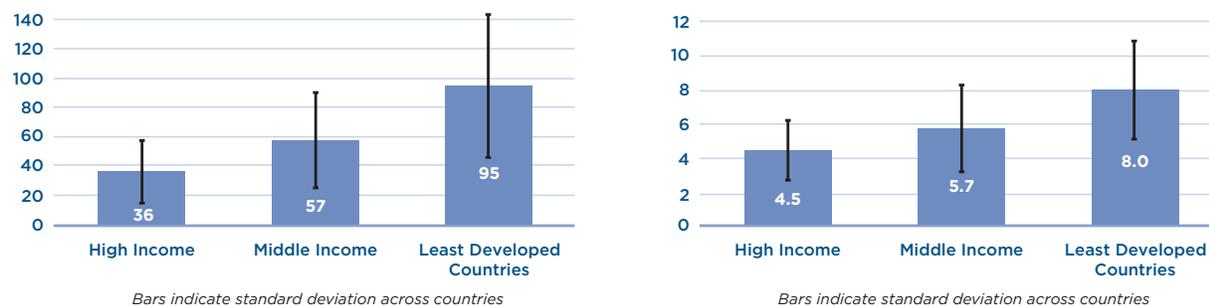
Source: Doing Business

The Enabling Environment for SME Finance

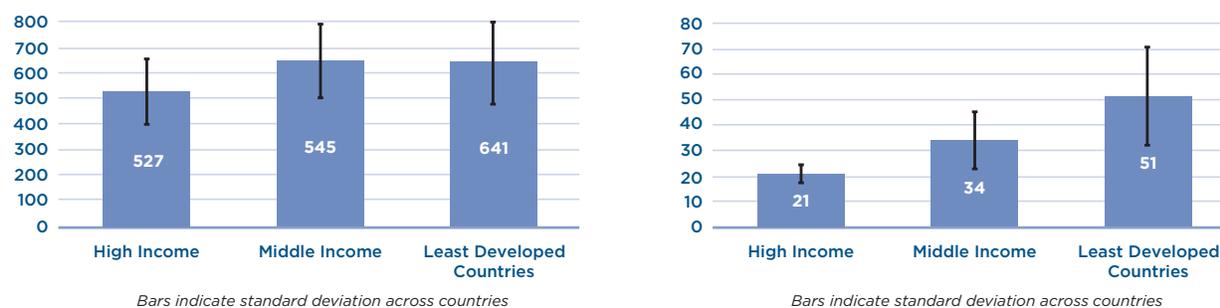
Two “Doing Business” indices measure differences in the legal framework and credit reporting systems. The “Strength of Legal Rights” index measures the degree to which collateral and bankruptcy laws protect the rights of borrowers and lenders and thus facilitate lending by reducing the probability of default or reducing losses of lenders given default. Effective collateral regimes contribute to SME finance by reducing the risks and losses of lenders. The Strength of Legal Rights index measures the efficiency of collateral law (Figure 8), and is lower for LDCs. The “Depth of Credit Information” index measures rules and practices affecting the coverage, scope, and accessibility of credit information available through either a public credit registry or a private credit bureau. Well-functioning credit information systems reduce adverse selection and moral hazard, and can contribute to both an expansion of credit and a reduction in lending costs. Not surprisingly, as figure 8 shows, LDCs scores are lower than those in higher-income countries. Figure 8 also shows substantial variation across countries in the same income groups, particularly in terms of credit information.

The results are in line with other indicators showing that LDCs face a more severe set of challenges and constraints in providing enabling policy guides for SMEs. Indicators particularly relevant for financial access are the time taken and cost incurred in registering property and enforcing contracts. Studies show that countries with lower entry costs and lower costs of registering property have a larger SME sector in manufacturing.⁹⁹ As shown in Figures 9 and 10, such costs are higher than average in LDCs. These indicators also show considerable variation across countries in the same income groups.

The combination of costly and lengthy registration and enforcement processes, along with weak legal rights, acts to constrain SME lending in LDCs. SMEs are more likely to fail at acquiring new land or buildings compared to large and medium firms. Difficulties in acquiring property and securing titles and construction permits means that firms are less competitive and less able to expand production and employment. This can contribute to financing gaps, not only because such firms have lower asset values that can be used to secure loan contracts, but also because they are less productive, rendering them less creditworthy. Registering and transferring real

FIGURE 9 TIME AND COST INVOLVED IN REGISTERING PROPERTY

Source: Doing Business Indicators

FIGURE 10 TIME AND COST INVOLVED IN ENFORCING CONTRACTS

Source: Doing Business Indicators

property, when property rights are not clearly defined, prevents firms from offering as collateral land, buildings, or movable property because of lack of clear titles or a missing system of information about liens against their property. At the same time, title transfer can be a complex process ranging from document collection and preparation to due diligence. In addition,

in the absence of secure property rights, entrepreneurs are likely to forego or limit investment opportunities to fixed assets rather than intangible ones, since it is easier to secure returns from fixed assets. Sound property rights therefore also play a significant role in firms' asset allocation and consequently growth, particularly of new firms.¹⁰⁰

100 Claessens and Leaven (2002).

ANNEX II

Abatement Curve Model

A significant amount of research has gone into quantifying the SME credit gap and identifying barriers such as reliable data with which to assess the credit quality of borrowers, incomplete property registration, or banks' cumbersome processes.

Jointly with the IFC, Oliver Wyman developed the SME Finance Gap Abatement Curve methodology, aimed at establishing a quantitative link between credit market reform initiatives (and implied investment) and the benefits of reducing barriers to SMEs' access to credit. It creates an objective framework to help policymakers decide where to focus limited resources to generate the greatest return on investment (e.g., employment, tax revenues). The methodology was applied to a sample of six countries: France, Kenya, Morocco, the Philippines, Turkey, and the United Kingdom. A key conclusion of relevance to policymakers is that the payback of any reform varies between countries: that is to say, each country has its own abatement curve. A common conclusion is that financial contribution to lending schemes (e.g., credit guarantees) is considerably less effective than addressing improvements in the underlying credit infrastructure (e.g., asset register, availability of financial information).

1) IDENTIFYING THE KEY DRIVERS OF THE "ADDRESSABLE"¹⁰¹ FINANCING GAP:

The model's basic premise is that policymakers should focus on understanding the risk/return dynamics of SME lending and use this to steer the focus of their

interventions. To the extent that such interventions run counter to basic free market principles, they tend to be unsustainable. With this in mind, policymakers should target the "addressable" financing gap with interventions that will change the state variables in such a way to minimize the distribution costs within the system, so that lenders maximize credit supply under reasonable return objectives. Three main cost components are the key drivers of an SME financing gap:

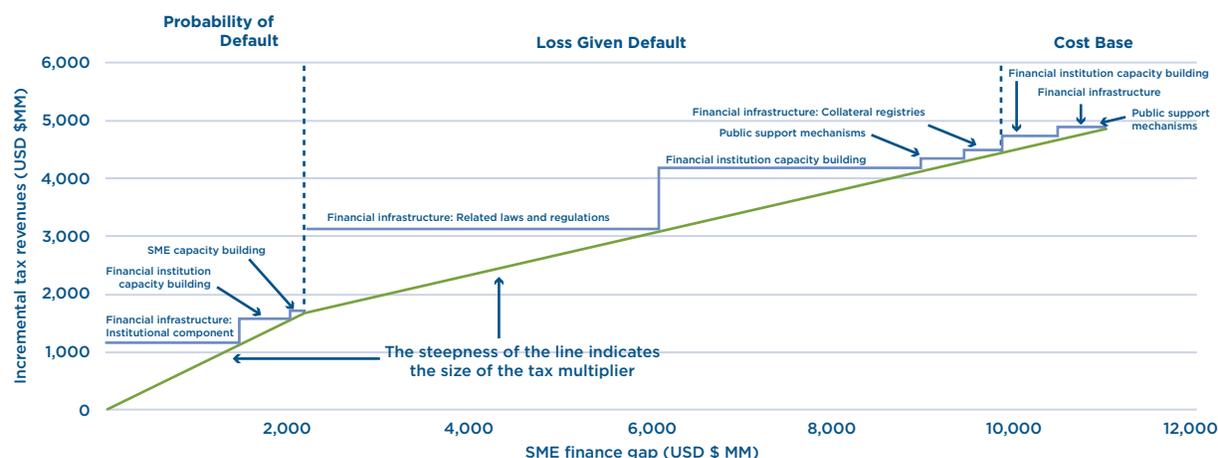
Probability of Default (PD): How much of the gap is a result of the fact that lenders are unable to differentiate between high and low risk credits, and therefore suffer from adverse selection? Even in markets with a structurally high default rate, sophisticated lenders will be able to identify – and finance – higher quality SMEs: this effect can be quantified via the PD of the SME loan portfolio "on the books" of lenders.

Loss Given Default (LGD): How much is due to the fact that lenders suffer from high loss rates in the event of borrower default, because of their inability to recover on collaterals held against the loans? The ability to take – and recover on – collateral as security against the debt is a significant risk management lever: again, it can be quantified via the LGD suffered by lenders to the SME sector.

Cost base: How much is due to inefficiencies in operating cost structures, or in higher than necessary capital and funding costs? The cost base of lenders to the SME market can be aggregated and its three major compo-

¹⁰¹ It should be noted, however, that this approach can only be applied to the "addressable" financing gap (i.e., the proportion of the total financing gap related to unnecessarily high distribution costs), and that neither this report nor the underlying model considers how best to tackle the "residual" financing gap.

FIGURE 11 SME FINANCE ABATEMENT CURVE



nents can be compared against best-practice benchmarks to determine the extent of unnecessary cost.

II) QUANTIFYING THE BENEFITS OF CLOSING THE “ADDRESSABLE” FINANCING GAP

The model next uses multiplier effects to calculate the second order effects that closing the addressable financing gap will have in the economy (part of which will flow back to government in the form of taxes). Given an acceptable rate of return for the taxpayer, this approach provides a framework for governing investment in intervention policies to reduce the SME finance gap.

The Oliver Wyman model applied this methodology on the same six markets examined previously. Given the uncertainties, the investigators aggregated the results of the sensitivity analysis into three categories:

- Low (0-15%) – least important driver
- Medium (15% - 50%): driver with significant, but not primary, impact on the gap
- High (>50%): driver with the greatest likely impact on the gap

Furthermore, the model only presents the results for the second order effects of closing the gap (i.e., the multiplier) at an aggregate level, as given below:

IMPACT OF DRIVERS ON FINANCING GAP

	UK	France	Morocco	Turkey	Kenya	Philippines	Tax Multiplier (average)
“Addressable” gap	13%	32%	45%	115%	82%	229%	
Drivers of gap							
Probability of default	Medium	Medium	Low	High	Medium	Medium	-0.35
Loss Given Default	high	High	High	Medium	High	High	-0.17
Cost base	Low	Low	Medium	Low	Medium	Low	-0.17
Tax Multiplier	~0.13	~0.17	~0.27	~0.20	0.31	~0.45	~0.25

The model asserts that the interventions that will have the most impact are those that successfully address the barriers associated with the cost component that contributes most to the addressable financing gap. The mapping between cost components, barriers, and potential interventions is illustrated by the table overleaf.

Taken in aggregate, these results provide guidance to policymakers on where to focus potential interventions:

- Across all markets, Loss Given Default is almost consistently the cost component that has the biggest influence on the addressable financing gap (usually >50%). This suggests that policymakers should prioritize interventions that address the barriers that artificially increase lender losses in the event of default. These might include improvements to the legal environment surrounding corporate bankruptcy, the creation of a collateral registry, or the foundation of a credit guarantee scheme (See table)
- In most countries, Probability of Default typically contributes to a moderate portion (~20-25%) of the addressable gap. Therefore, a second priority for policymakers should be to tackle barriers such as asymmetric information, as well as both lender and SME skill levels. Interventions might include the establishment of a business registry and/or credit bureau, and programs to provide technical assistance to lenders or improve financial literacy among SMEs (See table).
- The cost base of lenders contributes the least towards the addressable gap, with its influence varying between 5% and 25%, but tending toward the bottom of the range. This suggests that policymakers will have the least impact by intervening to lower

the operational costs or funding costs (e.g., ring-fenced funding schemes).

- The second order effects of closing the financing gap appear to be positive. Policymakers should expect tax revenues from SMEs to increase at roughly twice the rate that lending increases, as a result of successful interventions.

Interventions that address barriers associated with Probability of Default (i.e., asymmetric information, lack of skills on the part of both SME and lender) should have a disproportionate effect on tax revenues, due to the fact that lending is being skewed toward both more sustainable and more profitable SMEs. Those SMEs with a lower PD will typically have a higher operating margin than SMEs with a higher PD, which feeds through into both larger profits and tax take on aggregate. LGD and cost-related interventions do not have the same effect on the overall profitability of SMEs, and therefore do not result in such a big tax multiplier.

We note that these conclusions do not hold true across every market. In particular, the relative contribution of Probability of Default to the addressable financing gap in Turkey and Morocco appears to be out of line with the other markets, as does the relative importance of the cost base in Morocco and Kenya. However, that still offers a lot of information in and of itself. By digging deeper in Morocco, Turkey, and Kenya, the authors argue that these results are largely explainable (the former because of the cyclical adjustment to PD that is made within the model; the latter because of the significant inefficiencies in the banking sector in these markets).

ANNEX III

World Bank General Principles for Credit Reporting

General Principles for Credit Reporting

The General Principles aim at the following **public policy objectives** for credit reporting systems: Credit reporting systems should effectively support the sound and fair extension of credit in an economy as the foundation for robust and competitive credit markets. To this end, credit reporting systems should be safe and efficient, and fully supportive of data subjects and consumer rights.

Data

General Principle 1: Credit reporting systems should have accurate, timely and sufficient data - including positive - collected on a systematic basis from all relevant and available sources, and should retain this information for a sufficient amount of time.

Data Processing: Security and Efficiency

General Principle 2: Credit reporting systems should have rigorous standards of security and reliability, and be efficient.

Governance and Risk Management

General Principle 3: The governance arrangements of credit reporting service providers and data providers should ensure accountability, transparency and effectiveness in managing the risks associated with the business and fair access to the information by users.

Legal and Regulatory Environment

General Principle 4: The overall legal and regulatory framework for credit reporting should be clear, predictable, non-discriminatory, proportionate and supportive of data subject and consumer rights. The legal and

regulatory framework should include effective judicial or extrajudicial dispute resolution mechanisms.

Cross-Border Data Flows

General Principle 5: Cross-border credit data transfers should be facilitated where appropriate, provided that adequate requirements are in place.

ROLES OF KEY PLAYERS

Role A: Data providers should report accurate, timely and complete data to credit reporting service providers, on an equitable basis.

Role B: Other data sources, in particular public records agencies, should facilitate access to their databases to credit reporting service providers.

Role C: Credit reporting service providers should ensure that data processing is secure and provide high quality and efficient services. All users having either a lending function or a supervisory role should be able to access these services under equitable conditions.

Role D: Users should make proper use of the information available from credit reporting service providers.

Role E: Data subjects should provide truthful and accurate information to data providers and other data sources.

Role F: Authorities should promote a credit reporting system that is efficient and effective in satisfying the needs of the various participants, and supportive of consumer/data subject rights and of the development of a fair and competitive credit market.

RECOMMENDATIONS FOR EFFECTIVE OVERSIGHT

Recommendation A: Credit reporting systems should be subject to appropriate and effective regulation and oversight by a central bank, a financial supervisor, or other relevant authorities. It is important that one or more authorities exercise the function as primary overseer.

Recommendation B: Central banks, financial supervisors, and other relevant authorities should have the powers and resources to carry out effectively their responsibilities in regulating and overseeing credit reporting systems.

Recommendation C: Central banks, financial supervisors, and other relevant authorities should clearly define and disclose their regulatory and oversight objectives, roles, and major regulations and policies with respect to credit reporting systems.

Recommendation D: Central banks, financial supervisors, and other relevant authorities should adopt, where relevant, the General Principles for credit reporting systems and related roles, and apply them consistently.

Recommendation E: Central banks, financial supervisors, and other relevant authorities, both domestic and international, should cooperate with each other, as appropriate, in promoting the safety and efficiency of credit reporting systems.

ANNEX IV

Least Developed Countries

Afghanistan	Malawi
Angola	Maldives
Bangladesh	Mali
Benin	Mauritania
Bhutan	Mozambique
Burkina Faso	Myanmar
Burundi	Nepal
Cambodia	Niger
Central African Republic	Nigeria
Chad	Pakistan
Comoros	Papua New Guinea
Congo, Dem. Rep.	Rwanda
Côte d'Ivoire	Samoa
Djibouti	São Tomé and Príncipe
Equatorial Guinea	Senegal
Eritrea	Sierra Leone
Ethiopia	Solomon Islands
Gambia, The	Somalia
Ghana	Sudan
Guinea	Tajikistan
Guinea-Bissau	Tanzania
Haiti	Timor-Leste
Kenya	Togo
Kiribati	Uganda
Korea, Dem. Rep.	Uzbekistan
Kyrgyz Republic	Vanuatu
Lao PDR	Vietnam
Lesotho	Yemen, Rep.
Liberia	Zambia
Madagascar	Zimbabwe

ANNEX V

Resources, References

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