FIXED INCOME INSTRUMENTS TO MOBILIZE INSTITUTIONAL INVESTORS FOR SME FINANCING IN EMEs
Emerging market economies (EMEs) face significant funding gaps in strategic sectors, such as infrastructure and SME financing, that if not addressed could stifle growth. Traditional funding sources—whether government and/or bank financing—will not be able to meet this gap. In contrast, institutional investors in EMEs have experienced significant growth in the last decades and have a sizeable amount of assets under management. As a result they are increasingly being looked at as a potential alternative funding mechanism.

In this context, in 2015 the Finance and Markets (F&M) Global Practice led the production of a joint WBG/IMF/OECD Report for the G20 on “Capital markets instruments to mobilize institutional investors to infrastructure and SME financing in emerging market economies”. The Report focuses on fixed income instruments that can help mobilize domestic institutional investors, in particular pension funds and insurance companies, to infrastructure and SME financing in emerging market economies (EMEs) and provide policy recommendations to facilitate their use. The approach taken in the Report was qualitative and conceptual, drawing from our experience in the field to gauge the current use of these instruments, the challenges that EMEs face to develop them and potential lessons from relevant experiences in both EMEs and AEs.

This Compendium of Policy Notes complements such Report in the area of capital markets and SME financing. It is composed of six notes:

- The first note summarizes the key takeaways of the G20 Report as to the potential of different fixed income instruments to mobilize institutional investors for SME financing in EMEs, and the challenges for such mobilization to take place.
- Subsequent notes go into more depth on each specific instrument and their potential to help address the SME finance gap in EMEs, including experiences and innovations in their use across advanced and emerging market economies. The instruments analyzed included:
  - Bond issuances by SMEs,
  - Bond issuances by SME lenders,
  - Securitization of SME loans,
  - SME debt funds, and
  - SME covered bonds

The production of the joint Report and accompanying notes was led by Ana Fiorella Carvajal, Lead Securities Markets Specialist and involved contributions from many F&M colleagues, including Ketut Ariadi Kusuma, Shanthi Divakaran, Catiana Garcia Kilroy, Tamuna Loladze, Michel Noel, Fiona Stewart and Simon Walley, with collaboration from Jeffrey Anderson, Peter Casey, James Hammersley, and Richard Kemmish, external consultants. Staff from the IMF and the OECD also provided important contributions. The Report benefitted from the peer review conducted by Anderson Silva and Jeff Chelsky, while Loic Chiquier, Matt Gamser and Alison Harwood oversaw the project. The authors also wish to thank Aichin Lim Jones for providing the design and layout of this Compendium.
MOBILIZING INSTITUTIONAL INVESTORS FOR SME FINANCING: KEY LESSONS

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INTRODUCTION

Formally registered SMEs in emerging market economies (EMEs) face a significant credit gap, estimated at $0.9 to $1.1 trillion as of 2011, and access to finance is considered the biggest obstacle to SME growth. Banks have been the traditional source of SME funding but the financial crisis has led to an active debate about the importance of broadening the range of funding options available for SMEs. Institutional investors in EMEs hold a sizeable amount of assets under management (about USD $5 trillion at end 2012 for pension funds and insurance companies). As a result they are increasingly being looked at as an alternative funding mechanism that could help fill this gap. However, their potential and viability within the SME reality need to be carefully explored.

This note summarizes key takeaways regarding the potential of different fixed income instruments to mobilize institutional investors for SME financing, and the challenges (and preconditions) for such mobilization to take place. The instruments analyzed include: bond issuances by SMEs, bond issuances by SME lenders, securitization of SME loans, SME debt funds and covered bonds. Tables I and II provide an overview of the main characteristics of these instruments.

KEY TAKEAWAYS

SMEs are inherently better suited for bank funding and asset based lending due to their particular characteristics – small size, informal nature, and limited information – which make it difficult to ascertain the quality of an SME business from a capital market investor’ perspective (arms’ length). Banks and other specialized lenders are better able to operate in this opaque environment as they rely on relationship-based finance, which provides them with personal insights into a business that would not be otherwise visible to outside investors. Asset-based lending can also more easily mitigate the information problems of SMEs, given the existence of assets to support any lending activity. As a result enhancing access to bank and asset based lending should remain a priority.

The role of capital markets, and in particular institutional investors in the direct financing of SMEs via fixed income instruments is limited. In particular, bond issuances are an alternative potentially suitable only for larger, more formal SMEs. This is due to both supply-side and demand-side factors.

• On the supply side, most SMEs, due to their small size and relatively informal nature, lack the capacity to prepare their businesses for an offering of securities to the public, which requires meeting a set of disclosure requirements on an initial and ongoing basis. Some avenues
for fund raising, such as exempt and/or private offerings can significantly reduce disclosure requirements vis-à-vis the market and the securities regulator. However, investors would still require some minimum level of information, which most SMEs would find difficult to prepare.

- **On the demand side**, institutional investors, while attracted to the higher yields offered by potential SME issuances, in general, do not find it economical to invest in individual SME bonds due to their small size as they would have to assemble a large number of SME issuances to see a meaningful impact of the higher yields on their portfolios. Moreover, lack of easily available information on SME performance makes it difficult or not worthwhile for institutional investors to select and monitor individual SME deals. Finally, many institutional investors have minimum risk rating requirements, which are difficult to comply with for most SMEs. For these reasons, only the larger, more formal, and better known SMEs – i.e., the midcap segment – could be potentially attractive to institutional investors.

**SME bond funds**, which have been launched in certain EME markets, such as is the case in Peru, can help overcome some of the demand side challenges explained above and thus increase the appetite of institutional investors for SMEs. By pooling individual bonds issued by SMEs and offering larger investment units to investors, they overcome the size challenge; they also provide risk-return diversification by investing in a variety of SMEs across sectors and sometimes geographies; finally, they have specialized expertise to source suitable SME bond investments and monitor them over time.

**Capital markets** can play a larger – albeit indirect – role in SME financing through the refinancing of SME lenders. This is the avenue that currently holds the largest potential to mobilize institutional investors to SME financing. The evidence from EMEs shows that institutional investors can play an important role in SME access to finance by providing financing to SME lenders (banks, microfinance institutions, factoring and leasing companies), which in turn can have a positive effect in the availability of a steady flow of funding to SMEs, their ultimate beneficiaries.

In the short to medium term, such financing would likely take place via plain vanilla instruments – corporate bond issuances by SME lenders. Bank issuances are already the most common securities in EMEs, even in nascent capital markets, and generally carry attributes that appeal to the risk-return appetite of institutional investors: higher yields than government bonds; acceptable credit ratings; and sufficient size. Issuances by more specialized SME lenders are also starting to take place across EMEs, as the examples from countries in Latin America and Sub-Saharan Africa demonstrate. However, they may require credit enhancements to align them with the risk-return appetite of institutional investors.

Over time, as markets develop, more complex instruments could have the potential to integrate bank and asset based lending with capital markets, such as securitizations and fund structures that can help SME lenders offload SME loans and other credit assets, thereby freeing up capital that could be used for generating new lending. They could also be used by SMEs themselves to offload receivables, thus allowing them to improve their liquidity. Investors benefit from the ability to invest in otherwise non-tradable assets at an acceptable size and risk-return level and access to continuous steady cash flows at attractive yields. Most of these instruments are still at a nascent stage even in developed jurisdictions. However, some of these structures are starting to be tested in larger EMEs. For example, SME securitization is being used in Korea and India, while funds based on factoring and reverse factoring exist in countries such as Peru and Chile.

**KEY CHALLENGES AND PRECONDITIONS**

For many EMEs further development of the institutional investor base is the first precondition to enhance their role in SME financing via the mechanisms explained above – although there is no predetermined cut-off size that such investors should reach. However, even in EMEs where such an institutional investor base already exists, their potential to bridge key financing needs such as those related to SME financing has not fully materialized. To a large extent this is due to challenges that affect key preconditions. These relate to: the availability and offering of the instruments (supply side); investment conditions for institutional investors (demand side); and the broader enabling environment.

It is important to highlight that significant innovation is taking place in product design that can potentially expand the role of institutional investors in SME financing. New instruments and lending mechanisms, such as joint SME bond issuances and electronic platforms for lending seem to be addressing the scale/volume problem that limits institutional investors’ appetite for SMEs. However, it is still too early to assess the impact that such innovations will have.
Supply side

Lack of a robust pipeline of SMEs and SME related assets is one of the core challenges to developing SME capital market instruments for institutional investors’ investment in EMEs. This includes the lack of a sufficient number of midcap companies that could issue bonds and thereby raise funds directly from capital market investors. It also includes the lack of a sufficient volume of “relatively standardized” SME loans, backed by robust credit information that could serve as underlying assets for instruments used to refinance SME lenders, such as SME loan securitizations and SME loan funds. The low volume of SME loans, in turn, has to do with the shortage of “quality” SMEs that would be considered bankable by lending institutions.

The challenge of not enough bankable SMEs is not simply the result of a low number of quality SMEs but is often related to challenges linked to credit infrastructure that constrain the ability to properly assess the creditworthiness of SMEs, whose businesses may in fact present attractive investment opportunities. This includes underdeveloped credit bureaus and credit information tools, lack of recognition of movable assets as collateral and absence of collateral registries, as well as poor insolvency frameworks that do not facilitate reorganization of a business. In addition, efforts are needed to strengthen the financial skills and governance of SMEs to improve their formalization and preparedness for lending and, at a later stage, potential for capital market investment.

Also, many EMEs still need to put in place the legal and regulatory framework to support the creation of fixed income instruments. In many EMEs there is already a framework in place for certain basic instruments, in particular bond issuances. There are more challenges in relation to other instruments. For example, many of the instruments to link banking and asset-based lending and capital markets rely on the framework for securitization, which, among other things, requires clear rules in relation to the assets that can be securitized, and the requirements that such assets must meet, and robust special purpose vehicles (SPVs) that are bankruptcy remote. For covered bonds, a dedicated legal framework with a clear definition of eligible assets and minimum quality standards is needed. For fund structures, a robust framework for closed-end funds is needed which --as the framework for securitization-- requires clear rules on asset eligibility and robust legal structures for the fund themselves. Yet, some of these more specialized frameworks are not in place or are incomplete in many EMEs.

Finally, many EMEs would benefit from developing streamlined offering regimes targeted to institutional investors. Such issue regimes reduce or eliminate disclosure requirements that apply for public offerings and simplify or eliminate regulatory approval, which greatly facilitate the offering process and help reduce issuance costs and time-to-market. For this reason, they are very attractive to issuers and institutional investors in advanced economies.

Demand side

In many EMEs rigid investment frameworks can pose a challenge to institutional investors’ ability to invest in SME related instruments. Proper regulation of institutional investors is critical given their mandates and fiduciary duties towards their beneficiaries. However in some EMEs the rules-based investment frameworks in place are overly prescriptive and they significantly limit and sometimes prohibit investment in alternative assets, under which some of the SME instruments could fall. In addition, as EMEs progress in the implementation of solvency frameworks for insurers, there would be the need to ensure that such frameworks make appropriate distinctions between different asset classes and/or tranches (i.e. high quality loans or senior tranches should in principle have a better capital treatment).

Another challenge is the limited capacity of domestic institutional investors in many EMEs to analyze instruments beyond very basic products. This could potentially be an issue for some of the more complex structures used for SME securitizations that require stronger risk analysis skills. The need to develop simple, transparent and comparable instruments has been highlighted as a key initiative to restore confidence of institutional investors in certain types of instruments, such as securitization structures. Efforts are underway both at the standard setting level and at the market level, the latter in industrialized jurisdictions. EMEs will also benefit from these efforts, especially given that EME investors are less experienced and more used to investing in plain vanilla instruments.

Finally, some of the SME related instruments are likely to require external credit enhancements to improve their risk-return profile and attract institutional investor appetite in EMEs. Given their lower experience, regulatory requirements and/or internal limits and policies, EME investors are usually less willing to take on risks imbedded in non-traditional investments and prefer highly rated securities. For this reason, until SME instruments become more established in a market, credit enhancements, such as partial credit guarantees or insurance, will play an important role for a successful introduction of new instruments. In
many EMEs credit guarantee programs already exist to support SME lending. The challenge and opportunity lies in finding ways to optimize such programs and link them to capital markets solutions as has been the case in some industrialized jurisdictions (i.e. Spain).

**Enabling environment**

The development of SME related fixed-income instruments also depends on certain important preconditions being present in the broader enabling environment. First and foremost, a minimum level of fixed income market development, along with basic securities market infrastructure and regulatory framework, is needed before the introduction of more unconventional instruments can be considered. This entails putting in place the following key market building blocks:

- A deep and liquid government bond market with issuances covering a broad range of short-, medium- and long-term maturities to provide reliable pricing benchmarks for non-government instruments.

- Well-functioning money markets to provide reliable pricing at shorter tenors (less than one year) and help anchor the entire yield curve; they are also important for supporting liquidity and short-term financing of market participants that invest in intermediate fixed-income markets.

- Key market infrastructure, including payment systems, central securities depositories and custodians to ensure that transactions are carried out safely and reliably and, hence, generate trust among market participants to engage in capital market transactions.

- Credit rating services, ideally with robust and transparent methodologies for rating debt issuances and adequate mechanisms to mitigate conflicts of interest, to support investors in determining the creditworthiness of investments.

- Strong regulation and supervision of capital markets, focused on ensuring market transparency and integrity, to build confidence among market participants to engage in market transactions.

In addition, certain preconditions outside of the capital market sector have an important influence on the incentives of potential issuers and investors to participate in the market. These include:

- A stable macroeconomic environment with transparent and predictable inflation, interest and exchange rate policies that fosters a level of certainty among market participants.

- A clear and stable tax framework, especially in connection with the transfer of assets in a securitization structure, but also more generally with different types of investment products, ensuring that non-government instruments are not disadvantaged due to unfavorable tax treatment vis-à-vis other investment options (e.g., government securities or banking products).

- A robust and reliable rule of law, judicial procedures and insolvency frameworks which underpin the broader perception and confidence about operating in a particular market.

**THE ROLE OF GOVERNMENTS AND DEVELOPMENT INSTITUTIONS**

EME governments must develop comprehensive policies and strategies aimed at addressing the SME financing gap, along with the corresponding actions plans. These strategies should take into consideration the complementary role that capital markets can play vis-à-vis banking financing, and be well articulated into broader capital market development plans. The plans should aimed at strengthening the preconditions necessary for the instruments to develop, by ensuring that an enabling environment is in place and that the supply and demand side challenges identified earlier are addressed. The Chart below summarizes key recommendations provided in the G20 Report in the area of SME financing.
 Chart 1: Key Recommendations to mobilize institutional investors for SME financing via fixed income instruments

As challenges are complex and affect many stakeholders (both in the public and private arena), strong leadership is needed, as well as appropriate involvement of all stakeholders in the definition of such a strategy and the prioritization of actions. In this context, it is recommended that the authorities:

- Appoint a responsible champion that can lead and shepherd the process forward;
- Establish high-level committees to support the development and implementation of the strategies, which would be represented by key public and private sector stakeholders; and
- Make the strategies and action plans publicly available and require periodic reporting on the progress made.

Development institutions can support EME governments in the design and implementation of national strategies. This includes (i) providing advice, (ii) serving as an honest broker to help mobilize interest and build consensus, (iii) designing and offering risk-sharing mechanisms, structuring and underwriting instruments and (iv) participating in demonstration transactions with catalytic impact on market development. In this regard, as highlighted in the G20 Report, it is critical that they be in a position to provide an integrated solution to EME governments, where all types of services are aligned to achieve this common objective of enhancing SME financing, and designed to support and complement each other. In this context they should also continue to reassess the instruments through which they have provided support to SME financing, and develop strategies that integrate the use of both banking and capital markets solutions in ways that ensure the optimal use of all types of funding.
Table 1: Mechanisms To Provide SMEs With Direct Access To Capital Markets

<table>
<thead>
<tr>
<th>Type of instrument</th>
<th>Corporate bond issuances by SMEs</th>
<th>SME bond funds</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Issuances via private placement</td>
<td>Pipeline of bonds issued by SME companies</td>
</tr>
<tr>
<td></td>
<td>Issuances via private placements to qualified investors</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Issuances via public offerings in alternative markets</td>
<td></td>
</tr>
<tr>
<td>Supply side</td>
<td>Small and medium size SMEs, with certain level of formality</td>
<td>Larger, more formal and more solid SMEs</td>
</tr>
<tr>
<td>Demand side</td>
<td>Retail and potentially high net worth</td>
<td>Institutional and high net worth individuals</td>
</tr>
<tr>
<td>Securities markets framework</td>
<td>Carve out from the public offering regime</td>
<td>Carve out from the public offering regime</td>
</tr>
<tr>
<td>Other supporting legal framework</td>
<td>Framework for corporations</td>
<td>Framework for corporations</td>
</tr>
<tr>
<td>Disclosure requirements</td>
<td>Typically none</td>
<td>Varies from limited to no information requirements by regulation. In practice institutional investors might demand information including an offering circular and a rating for debt products</td>
</tr>
<tr>
<td>Corporate governance requirements</td>
<td>No</td>
<td>No</td>
</tr>
<tr>
<td>Framework for the institutional investors</td>
<td>Must allow investment in securities of private offerings. Frameworks usually require a minimum rating for debt securities</td>
<td>Must allow investment in securities of private offerings. Frameworks usually require a minimum rating for debt securities</td>
</tr>
<tr>
<td>Credit rating</td>
<td>Typically no, as this offerings are not typically addressed to institutional investors</td>
<td>Usually required by institutional investors</td>
</tr>
<tr>
<td>Taxation framework</td>
<td>Typically no tax incentive</td>
<td>Typically no tax incentive</td>
</tr>
</tbody>
</table>
### Table 2: Mechanisms To Refinance SME Lenders

<table>
<thead>
<tr>
<th>Preconditions</th>
<th>Corporate bond issuances by SME lenders</th>
<th>SME securitization</th>
<th>SME covered bonds</th>
<th>SME loan and credit funds</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Supply side</strong></td>
<td>Banks, microfinance institutions, factoring and leasing companies</td>
<td>Pipeline of SME loans, with quality information</td>
<td>Pipeline of SME loans, with quality information</td>
<td>Pipeline of SME related assets, such as SME loans, trade receivables, with quality credit information</td>
</tr>
<tr>
<td><strong>Demand side</strong></td>
<td>Potentially all investors, but in particular institutional</td>
<td>Mainly institutional</td>
<td>Mainly institutional</td>
<td>Mainly institutional and high net worth</td>
</tr>
<tr>
<td><strong>Securities markets framework</strong></td>
<td>Usually nothing additional</td>
<td>Framework for securitization</td>
<td>Framework for covered bonds</td>
<td>Framework for CIS, in particular close-end funds</td>
</tr>
<tr>
<td><strong>Other supporting legal framework</strong></td>
<td>Depending on the issuer, legal framework for banks, factoring, leasing</td>
<td>Legal framework for SPVs</td>
<td>Nothing additional</td>
<td>Depending on underlying asset, framework for secured transactions, factoring or leasing</td>
</tr>
<tr>
<td><strong>Framework for the offering</strong></td>
<td>For public offering, prospectus and periodic and ongoing information, including at a minimum semi-annual reports with audited financial statements and material events</td>
<td>Depending on whether placed via a public or private offer. For both, best practice is to provide granular information on underlying pool of assets required</td>
<td>Depending on whether placed via a public or private offer. For both, best practice is to provide granular information on underlying pool of assets required</td>
<td>Depending on whether placed via a public or private offer. For both, best practice is to provide granular information on underlying pool of assets required.</td>
</tr>
<tr>
<td><strong>Corporate governance requirements</strong></td>
<td>Not for the offering, but the respective institution might be subject to CG based on its own framework</td>
<td>Framework to address conflict of interest, including retention requirements and prohibitions of related party transactions</td>
<td>The covered bond law would have provisions related to the obligation of the bank to replace non performing portfolio</td>
<td>Governance of the CIS</td>
</tr>
<tr>
<td><strong>Framework for the institutional investors</strong></td>
<td>This would be a typical investment Frameworks usually require a minimum rating</td>
<td>In some countries, structured products are treated separately. The framework must allow investment on them Frameworks usually require a minimum rating</td>
<td>No experience in EMEs with the treatment of covered bonds. They would probably fall under the category of fixed income/corporate bonds</td>
<td>In some countries, investment funds are treated separately. Thus the framework must allow this type of investment.</td>
</tr>
<tr>
<td><strong>Credit rating</strong></td>
<td>Usually required</td>
<td>Usually required</td>
<td>Usually required</td>
<td>Not usual</td>
</tr>
<tr>
<td><strong>Taxation framework</strong></td>
<td>Typically no tax incentive</td>
<td>Require favorable treatment of the transfer of assets</td>
<td>Require favorable treatment of the transfer of assets – when moving assets in and out of the cover pool, and in case of insolvency of the issuing entity, when the cover pool operates like a SPV</td>
<td>Requires taxation as a pass through</td>
</tr>
</tbody>
</table>
CORPORATE BOND ISSUANCES BY SMEs

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BACKGROUND

In general, direct issuance of capital market instruments by SMEs has been limited in absolute and relative terms because of both supply- and demand-side constraints.

• On the supply side, issuance requirements for public offers, such as initial and ongoing disclosure obligations, tend to be too demanding and costly for smaller inexperienced companies to comply with. For equity issuance, this process is even harder because of corporate governance requirements, which are very difficult, if not impossible, to comply with for SMEs, many of which are family owned businesses. Issuance mechanisms that provide some degree of simplification to disclosure requirements, costs, and process can help alleviate these supply-side challenges. These “alternative” issuance regimes are discussed below.

• On the demand side, involvement of institutional investors in the direct purchase of SME securities has been virtually non-existent mainly because of the small size of issuances characteristic of SMEs. Institutional investors find it too costly to analyze and monitor many small issuances when they are looking to place sizeable investment assets. As a result, issuances by SMEs have primarily targeted retail investors, but this segment is small and underdeveloped in many jurisdictions, especially in EMEs. Specialized funds that invest in SME securities can help open access to the sizeable pool of institutional capital by being able to aggregate many small issuances and offer larger investment shares to institutional investors along with diversification and monitoring expertise. These fund mechanisms are discussed in detail in the note on SME Debt Funds.

TYPES OF ISSUANCES REGIMES

In general companies can issue bonds by way of a public or private offering regime. Each regime has different implications for SMEs. Public offers require companies to comply with a series of disclosure requirements at the moment of authorization and on an ongoing and periodic basis. Given the costs of providing this disclosure, public offers do not suit well SMEs. In an effort to facilitate SMEs access to the public markets, some countries have developed public offering regimes exclusively for SMEs, along with trading platforms that cater to them (on the exchange or as separate alternative trading platforms), which are sometimes called “alternative markets”. Private offers, in turn, allow companies to raise capital under significantly streamlined requirements, or even no requirements at all depending on the country and the exemption under which they are made. These exceptions usually include a maximum size of issuance and a limited number of investors, and in some countries also offers addressed exclusively to qualified investors. Other countries have established “hybrid” regimes for the
latter type of offers, which are then made under a streamlined regime. Theoretically, the more streamlined requirements of all these offers could be better suited for SMEs.

Public offering regimes for SMEs

Public offer regimes for small companies or issuances—typically defined by company revenue or maximum issuance size in a given period, respectively—allow issuers to comply with reduced requirements while still being able to access the public markets based on the principle of proportionality; that is, the requirements are scaled down to make them proportionate to the smaller size/issuance of the company. The offering regime is usually part of an alternative market, which allows SMEs to list their securities on an exchange or trading platform, typically within a special segment. The reductions vary from country to country but usually include: some rationalization in disclosure requirements (fewer years of financial information in the prospectus, less frequent periodic reporting and more time for preparing such reports), less stringent corporate governance requirements (e.g., number of independent directors, use of committees, thresholds for mandatory tender offers, etc.) and more flexible performance indicators. In addition, financial costs of issuance (e.g., registration, listing) are usually significantly reduced as well.

Historically, alternative markets were launched with equity markets in mind, especially in places where SME exchanges were the main drivers. These markets have been developed in AEs and the larger EMEs. Some examples in AEs include Alternative Investment Market in the UK, Alternext for Euronext which covers three markets in Europe (Belgium, France, and Portugal), the Mercado Alternativo Bursatil (MAB) in Spain, the Mercato Alternativo del Capitale (MAC) in Italy and TSX Venture Exchange in Canada. In EMEs, they can be found primarily in the larger EMEs, for example, WSE NewConnect in Poland, JSE AltX in South Africa, KONEX in Korea, and ChiNext in China, among others.

However, more recently alternative markets dedicated to debt have started to emerge. These include specialized bond exchanges and platforms that cater specifically to SME bond issuers (e.g., LSE’s Electronic Order Book in the UK, Bond platform on Stuttgart Borse in Germany, etc.). Among EMEs, Peru has developed an alternative debt securities market, the Mercado Alternativo de Valores (MAV), which is open to companies with minimum annual revenues not exceeding $70 million. It is a public offering regime with an associated listing platform within the Lima stock exchange.

In general, alternative markets are geared mainly toward retail investors because of the small size of issuances. In fact, a WBG survey of SME exchanges indicates that the majority of investors in these markets have been retail “because, for many institutional investors, SME issues are too small and lack the liquidity, reputation, access to information, governance, and risk profile they need.”1

A handful of SME bond exchanges are being set up with institutional investors in mind (e.g., Spain’s Mercado Alternativo de Renta Fija, MARF), where only institutional investors are able to access the instruments. However, these platforms have been less successful so far likely because they continue to have the mismatch between the typically small SME issuances and institutional investor appetite for more sizeable investments.

Private offerings/placements

In general, the requirements mentioned above are imposed only on public offers of securities, i.e., on offers made to the investing public at large. In practice most countries develop a series of criteria to determine when a public offer has taken place. In turn, offers that do not meet such criteria are considered exemptions to the public offering regime, and thus not subject to such requirements. The typical criteria used by the majority of countries in both AEs and EMEs relate to the number of investors involved and/or the (maximum) size of issuance. If an offer is too small, and/or the number of investors too limited it is considered that there is no public interest in regulating such offers. Thus traditional private offerings which are open to equity or debt securities, lie outside the public offer domain and hence usually outside the remit of securities regulators.

Private offerings have potentially large advantages for SMEs, as they usually completely eliminate the supply-side challenges related to disclosure, regulatory review and approval. Traditional private offerings usually have no initial or ongoing disclosure requirements from the regulatory point of view. Information about the offer is provided directly to investors prospected to purchase the offer. There is also no approval or monitoring of the offer by the regulator; though, in rare cases, a simple information document must be filed with the regulator for information purposes only.

As these offerings are usually considered to be outside the scope of the securities regulator, there is very limited information available on their use by companies. However, based on the experience in EMEs, it is possible

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to conclude that, in practice, offerings that are issued under these types of exceptions are too small to be attractive to institutional investors.

Regimes for offers addressed to sophisticated investors

Many countries also rely on the type of investors to which an offer is addressed to make distinctions in the offering requirements. This condition can be imposed directly, by providing differentiated requirements for offers addressed to sophisticated investors (professional, institutional and high net worth) or indirectly, by establishing a minimum denomination for the securities (high), which presumes the type of investor behind such investment. In some countries offers addressed to sophisticated investors are considered simple exemptions to the public offering regime, with no requirements (see for example the EU) or private offers that as explained above will not be subject to regulatory requirements (see for example Canada and Mexico). In others a hybrid regime has been developed that has some of the elements of traditional private offerings but lies closer to the regular public offering on the issuance spectrum. These type of offering regimes can be open to equity or debt securities, though, often they are specifically set up for debt instruments, which tend to be more institutional by nature and hence, already targeting the eligible investors of this type of regime.

Hybrid offer regimes usually do not completely eliminate disclosure requirements and the regulatory approval process (though, some do) but rather significantly reduce them based on the assumption that targeted investors are sufficiently sophisticated to analyze risks and make investment decisions. For example, initial disclosures can include a shorter and more simplified offering document and approval can be reduced to a few days or even made automatic upon submission of required information. In general these securities are traded among institutional investors over the counter; though, some jurisdictions have specialized institutional platforms within the exchange (e.g., Israel, India), where such offers can be traded without the risk of leaking to retail investors.

Offering regimes for sophisticated investors are an old phenomenon in places like the US, and to some extent the EU (although the use of this regime has significantly picked up after the crisis) and have been more recently adopted in select EMEs with others looking to follow suit. Examples in EMEs include Instruction 476 Restricted Efforts regime in Brazil, Private Placement (Accredited Investor) regime in Thailand, Institutional Investor Market in Peru, among others. These are examples of non-SME specific hybrid offer regimes. There are a few examples of hybrid offer regimes specifically designed for SMEs. Among them is, for instance, Italy’s so-called “minibond” regime, which has fewer and simpler regulatory requirements and tax relief similar to that applicable to listed companies, along with a dedicated trading platform accessible only to qualified investors.

Hybrid offer regimes have seen varied success in the EMEs that have adopted them when looking at their use for debt issuances. For the most part, they have attracted a sizeable portion of total issuance but usually at the expense of the regular public offer issuance; that is, issuance has simply shifted from the public to the hybrid offer regime. However, in a few countries, it is possible to observe an overall increase in the value of issuance of debt securities or some combination of an increase in the number of issuers or issuances following an introduction of a hybrid offer regime. For example, in Brazil the annual issuance value in 2014 (BRL 140 bn) was nearly double that in 2008 (BRL 74 bn), the year before the hybrid offer regime was introduced, an increase that was also accompanied by a rise in the total number of issuers. Moreover, there was a marked increase in the number of first-time issuers and number of issuances, along with a decrease in the average issuance size – all of which could suggest that the hybrid offer regime might have been helpful in encouraging smaller, less established issuers to come to market.

IMPLEMENTATION MEASURES AND CHALLENGES IN EMES

The above direct issuance avenues make up a set of issuance options that are useful to have alongside the regular public offer framework, to give issuers, including SMEs, choices in how they can access the market. Not every country needs to have all these options available, but more choices will offer added flexibility as potential SME issuers consider accessing capital markets.

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2 From a legal standpoint, hybrid offer regimes reside either on the private or public offering side, depending on the country context. If carved out of the public offer regime, they would typically be considered exempt public offers.


4 This observation is not based on thorough econometric analysis and hence does not take into consideration many other factors that could influence nongovernment bond issuance (e.g., level of interest rates, banking sector liquidity, etc.). It is simply an observation based on available issuance data. Source: Loladze, Tamara. “Hybrid Issuance Regimes for Corporate Bonds in Emerging Market Countries. Analysis, Impact, and Policy Choices,” World Bank Working Paper, June 2015.
Implementing successful SME public offering regimes, along with an alternative market, might be a challenge for many EMEs. From a regulatory perspective, in many EMEs issuance requirements for regular public offers are already too low, making it difficult to lower them further without undermining investor protection. And too subtle reductions would likely not make a material difference to attract SME issuers. Further, there are financial challenges for the implementation of the markets themselves. In addition to fixed costs involved in setting up necessary infrastructure for an alternative exchange, the fees for issuers (e.g., listing, custody) are significantly reduced by alternative exchanges. This coupled with a limited number of companies coming to list and small issuance sizes typically makes these exchanges financially unviable and in need of being subsidized by the main board.

Such challenges do not exist in the case of private offerings and hybrid regimes. In these cases, however, challenges might stem from the demand side, as will be further explained below.

CONCLUSION

The above issuance avenues serve as different approaches for mitigating supply-side constraints faced by SMEs. However, they do not eliminate constraints on the demand side. In this regard, in particular in connection with institutional investors, issuance regimes do not address issues of size and risk profile, which are key determinants of the lack of interest of institutional investors in traditional SMEs. Further, in many EMEs, institutional investors can only invest in securities that meet certain minimum grade, which SME bond issuances are usually not able to meet. On the retail side, retail investors’ lack of knowledge about these companies is a key issue affecting their investment. Fund mechanisms that can aggregate small issuances of SMEs can potentially help attract institutional as well as retail investors.

There are also broader cultural challenges among SMEs that serve as a bigger obstacle to SME issuance. These relate to the limited knowledge that many of them have of the options that capital markets can provide, and their ability to produce any information necessary—even if streamlined. These types of challenges limit the pool of SMEs that could be candidates for securities issuance and would need to be addressed overtime through efforts, such as business education campaigns, government programs to support SMEs, and general maturation of the corporate sector.
BACKGROUND

A corporate bond issued by SME lenders—banks, microfinance institutions (MFIs), and other non-bank financial institutions (NBFIs)—is the simplest, albeit indirect, instrument for increasing access to finance for SMEs through capital markets. Simply put, the proceeds raised through bond issuance increase the lender’s available funding, allowing it to, in turn, increase its lending operations. The greater the focus of a lender on the SME segment, the greater the impact of the issuances on SME lending. In this regard, for example, the issuance of corporate bonds by banks might not have a direct impact on SME lending given that banks engage in many different activities beyond SME lending. On the other hand, issuance by an MFI or an NBFI specializing in SMEs will have a more direct link with SME beneficiaries.

POTENTIAL BENEFITS

In addition to augmenting the lenders’ funding base, corporate bonds offer the following possible benefits to lenders, depending on the type of lender and its particular situation: longer tenor, potentially cheaper cost of funding, and diversification of funding sources.

Banks rely on deposits for funding, which are usually quite stable but are mostly short-term in nature. Access to an alternative funding source with a longer tenor increases a bank’s flexibility to expand lending to a more nonconventional, riskier customer segment like SMEs.

MFIs, unlike banks, are usually not deposit-taking institutions (though, some are or have the authorization to do so) and thus have relatively more unstable funding structures. They usually rely on bank loans themselves, which tend to be relatively short-term and may not be at very attractive rates, and sometimes donor contributions in the form of grants and public sector loans, which may or may not be renewable. In the face of growing demand for their services, MFIs are constantly looking for alternative sources of private capital. Their ownership and governance structure oftentimes presents challenges in issuing public equity to raise capital. As a result, debt issuance is sometimes their only viable alternative for increasing their capital base.

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5 In many countries, MFIs tend to have links with local governments such as municipalities.
BANCAMIA BOND ISSUANCE IN COLOMBIA

In December 2014 Colombia saw the first bond issuance by an MFI with a 5 year bond by Bancamia in the amount of around US$ 40 million (COP 100,000 million). Bancamia is the largest private MFI in Colombia, having a 17% market share in microcredit loans, which translates into a $538 million loan portfolio and about 380,000 borrowers as of June 2014. It targets exclusively customers at the bottom of the pyramid, with an average loan size of US$ 1,310.

While it has been a deposit-taking institution since 2008, almost 50% of its funding still depends on short-term bank loans. The bond will help the MFI diversify its funding structure and access longer-term funding in local currency. In addition, though the bond was fully subscribed by IFC with no other investors participating, it still provides the MFI visibility in the capital markets and serves as a stepping stone for future, more full-fledged issuances that could attract a wider range of investors.

The Bancamia bond was rated AA at the time of issuance and has since been downgraded to AA-. This was lower than the AA+ rating that is regularly demanded by Colombian institutional investors even though their regulations only require that they invest in investment grade securities. However, because IFC was the sole investor, no credit enhancement was necessary.

Bancamia was able to take advantage of streamlined issuance procedures of a hybrid offer regime for qualified investors, SegundoMercado, whose framework was recently improved through a new regulation introduced by the Colombian authorities in 2014. Bancamia was authorized for a bond program of up to COP 400,000 million (or around US$ 160 million) and is considering a follow-on bond issuance under the program in the near future.

With the increase in funding, Bancamia plans to expand its reach to 195,000 new micro entrepreneurs by 2018, of which 117,000 are expected to be for rural micro loans. This translates into a US$ 311 million increase in the loan portfolio.
MEASURES TO HELP INCREASE BOND ISSUANCE BY SME LENDERS

Fostering increased bond issuance by MFIs and similar institutions could be an important policy area for the SME finance agenda, given their direct link with SMEs, as mentioned above. Though more and more MFIs in EMEs are beginning to tap capital markets for funding, greater impact could be achieved by facilitating their access to this funding source with a number of supportive measures described below.

- **Alternative issuance regimes** – Most MFIs are relatively small and resource-constrained first-time issuers, finding it challenging to comply with public offer requirements in terms of time and costs required to prepare necessary documentation. Having in place an alternative issuance regime—such as a streamlined public offering for small companies or issuances, private offering based on a small number of investors or issuance size, or hybrid offer regime for offers targeted at qualified investors—is helpful to alleviate some of the burden related to the issuance process. These regimes reduce, simplify, or eliminate certain initial and ongoing disclosure requirements depending on the type of regime, and some also lower financial costs related to security’s registration and listing.

- **Credit enhancement**—Many MFIs are unable to achieve a credit rating that would be acceptable for domestic investors, given their riskier profile. Credit enhancements by domestic or international development organizations or public entities, could serve as an important catalyst for increasing investor interest in MFI issuance.

- **Anchor investment by international institutions**—Similar to credit enhancement, anchor investment by well-known international institutions, such as multilateral development organizations, would increase investors’ comfort in the MFI issuance by providing a stamp of approval for the issuer. Bancamia in Colombia provides one such example with IFC’s investment in its bond issuance; however, usually only a partial investment by a credible institution is sufficient to help crowd in domestic investors. This will likely be the model for Bancamia’s subsequent bond issuance.

- **General market development measures**—as with other instruments described in respective technical notes, measures to strengthen and deepen the overall securities market will also support growth in MFI issuance. Among these, particularly beneficial to MFIs would be: introducing more flexible investment regulations and eliminating minimum rating requirements for institutional investors, and building capacity and skills of investors in nongovernment bond investments, as well as raising their awareness about the MFI fixed income asset class, among others in the nongovernment bond category.

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7 See related Note on “Corporate Bond Issuances by SMEs.”
SME DEBT FUNDS

Ana Carvajal, Lead Securities Markets Expert and Tamuna Loladze, Securities Markets Specialist, both F&M GP

BACKGROUND

Investment vehicles that pool a variety of SME assets serve as a useful instrument in overcoming many of the challenges that complicate institutional investor involvement in SME financing. Currently, institutional investors invest in a subset of SMEs referred to as “high growth” companies (the gazelles) through growth and venture capital funds. The focus of this note is on expanding access to finance for “traditional” SMEs. Funds that hold the greatest potential in this regard and are relatively untapped to date are SME debt funds, which are discussed in the rest of this note.

DEFINITION

SME debt funds are collective investment schemes that pool together a variety of SME assets, from bonds issued by SMEs and SME loans to other types of credits such as trade receivables. They all have in common their goal of expanding the availability of capital for SMEs either directly (through funds specialized in SME bonds) or indirectly (through funds that package SME related assets that could have an impact on the availability of capital and/or liquidity for SMEs). As in all of them the underlying asset is a credit, investors in these funds receive as dividends the stream of income owed to the original creditor.

POTENTIAL BENEFITS

SME debt funds are becoming increasingly relevant instruments for mobilizing institutional investor capital for SME finance. By being able to aggregate a variety of SME assets, these funds provide several important benefits for institutional investors. First, similar to securitization, they are able to transform certain SME credit assets (e.g., loans, accounts receivable, leases), in which institutional investors are not typically allowed to invest in directly, into investable instruments. Second, by pooling together assets, funds provide institutional investors with diversification and larger size of investment, both key elements for their large holdings of capital. Finally, funds offer specialized expertise in selecting and monitoring individual investments, which institutional investors may find costly to develop in-house, especially if the overall share of allocation to the SME asset class is relatively small.
SME Debt Funds

TYPES OF FUNDS

SME debt funds cover a large variety of structures. One way to categorize this universe of structures, as applicable to SMEs, is according to underlying assets in which they invest. This results in three main types – loan funds, credit funds, and bond funds – discussed in more detail below.

SME loan funds

There are two main types of SME loan funds: co-origination funds and specialized loan funds.

Co-origination funds pool SME bank loans into structures that are similar to the securitization mechanism and, thus, their main benefit is to augment available bank financing for SMEs. This entails a type of partnership between the fund manager and participating banks, whereby the fund manager relies on banks to originate SME loans and the banks typically maintain the client relationship with the end-borrower, including the servicing of the loans. Similar to the ‘originate-to-distribute’ securitization model, banks sell their loans to the fund and benefit from risk transfer and capital relief. “Skin-in-the-game” arrangements are typically in place to ensure proper alignment of incentives and some funds impose other conditions to maximize benefits for SMEs, such as the requirement for banks to reinvest freed capital into new SME loans (e.g., Spain). The fund issues securities to be purchased by institutional investors, which are usually debt instruments backed by the underlying loans. This structure also allows tranching to cater to different risk profiles of institutional investors.

Specialized loan funds originate SME loans themselves instead of purchasing them from a bank, whereby the fund manager is involved in selecting, analyzing, and monitoring individual investments. In contrast to securitization funds, specialized funds typically cater to SMEs that are not able to access bank financing or may have financing needs that are greater than what they can access through banks. Here the fund manager plays a critical role in originating and monitoring the asset portfolio, requiring specialized expertise (e.g., credit risk analysis), as well as usually servicing the underlying assets. The instrument issued to investors is usually a share participation rather than a debt security and the fund is typically structured as a closed-end fund, with dividends corresponding to the stream of income received from the interest and principal of the underlying loans.

SME credit funds

SME credit funds, as used in this note, are specialized funds that invest in a variety of SME credit assets other than loans, such as accounts receivable, leases, supplier credit, etc. Similar to specialized loan funds, SME credit funds also aim to fill the funding gap left by banks but, in theory, cater to even a less ‘bankable’ SME universe, i.e., smaller and riskier SMEs that banks in many EMEs are reluctant to lend to. As a result, the only option for obtaining credit that is available for these SMEs is through non-bank institutions. Here too, the fund manager’s expertise in identifying, selecting, and monitoring the underlying assets for the fund’s portfolio is critical.

An example of this type of funds that has started to be used in some EMEs is based on the use of factoring, or purchase of account receivables owed to SMEs, which is done either directly by the fund or through specialized intermediaries called factors or factoring companies. The proceeds provide SMEs with immediate funding instead of having to wait for individual customers to pay their invoices. The receivables are purchased at a discount, which implies an interest rate that is typically lower than the rate SMEs can obtain for a bank loan (if bank funding is even an option). In the case where the fund purchases receivables directly, it can mobilize funding from local investors by issuing equity or debt securities, whose return (dividend/interest) is based on the cash flow received once these receivables are paid. In the case where the purchase of receivables is done through specialized factoring companies, a fund may provide loans to these companies and pass on to investors the interest and principal payments received on the loans.

A type of fund that could be particularly useful in EMEs is based on reverse factoring\(^*\), whereby the receivables to be acquired by the fund correspond to large companies with good credit quality, to which the SMEs provide good and services. As a result, the underlying risk of the cash flows is of these large, creditworthy, sometimes internationally known, companies that are SME customers rather than of the SMEs themselves. This type of structures can be particularly attractive in EMEs, where there are still significant challenges in credit culture, and credit information, and where there is still high risk averseness among local investors.

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\(^*\) Overall the objective of both factoring and reverse factoring is to finance the supplier’s receivables, so that the supplier can obtain immediate liquidity for the goods or services the supplier sold (minus an interest the factor deducts to finance the advance of money). In traditional factoring the process is originated by the supplier which selects the receivables eligible to be factored. In contrast, in reverse factoring the process is originated by the ordering party who then selects the receivables that will be eligible to be factored. As indicated above reverse factoring usually involve large companies to which the SMEs provide good and services.
SME bond funds

SME bond funds are specialized funds that invest in bonds issued by SMEs. Similar to other specialized fund types, bond funds are able to address the scale problem for institutional investors as well as provide them with diversification and monitoring expertise. They are also usually structured as closed-end funds with dividends corresponding to the income received by the fund from interest and principal payments of underlying bond assets.

Unlike the other fund types, they cater to the most sophisticated, larger SMEs that make suitable candidates for bond issuance. While this SME segment is also the most bankable, the advantage of bond funds for this subset of SMEs would be to facilitate potentially longer term and cheaper financing through bonds compared to bank loans. In addition, the more the larger SMEs can access funding through bonds, the more the banks will be encouraged to move down market and increase funding to smaller SMEs.

USE IN AEs

The use of SME debt funds has accelerated especially in the last few years both in Europe and the US. The majority of these funds are specialized loan funds that are often established by hedge funds or private equity funds, which are able to leverage their expertise of sourcing attractive acquisition deals and extend it to debt financing. In general, most debt funds in Europe target mid-cap companies and not the smaller SME segment. Information about the size and other data related to SME debt funds is rather scarce, given their relative novelty, heterogeneous nature, and small share of available investment instruments. Many SME debt fund initiatives are also still in the process of being established. According to the Alternative Investment Management Association (AIMA) survey of US and EU fund managers, $85 billion of a total of $530 billion of assets under management (AUM) of the funds surveyed accounted for private debt investments in 2014. Of this, about 30%, or roughly $26 billion, could be estimated to be directed toward SMEs. According to the European Investment Fund (EIF), 31 loan funds have been identified in Europe with a focus on SMEs, with a targeted volume of EUR 13.2 bn, out of a total of 95 active loan funds with a targeted volume of EUR 48.3bn.

Examples of loan funds targeting SMEs – both already active and in development – exist in the Netherlands, UK, Germany, Ireland, and Poland, among others, some of which include public support (see EIF 2014 for details). For example, in the UK, the Business Finance Partnership is a publicly supported initiative to invest in asset management firms that lend to SMEs. The government provides funding through two separate schemes, aimed at SMEs with turnover of up to GBP 500 mn and 75 mn, respectively. Public funding is conditional on the fund mobilizing at least the same amount from private investors. To date six funds have been established under the first scheme, providing loans to 18 medium-sized and 880 small businesses amounting to GBP 877 mn. Another interesting example is “Fond Novo” in France, which is a EUR 1 billion fund that takes loan portfolios from banks (with appropriate risk sharing in place) and issues a bond security backed by these loans. Unlike securitizations, the instrument is an untraded “whole loan” unrated debt security. Investors in the fund include Caisse des dépots and 17 large insurance companies.

SME bond funds are also starting to be used in Germany and France. For example in France GIAC, a government supported borrowing group, manages a EUR 80 million securitization fund, which invests in small to mid-cap bonds with issuance sizes ranging from EUR 500,000 – 2.5 million. The fund itself raises financing from the market by issuing different types of debt securities purchased by institutional investors. The fund has a partial guarantee scheme through a mutual fund, to which bond issuing companies contribute 7% of their respective issuance amount.

USE IN EMEs

SME debt funds are even a greater novelty in EMEs, though a few interesting structures are starting to emerge that take advantage of local SME context and institutional investor appetite. SME loan funds are less prevalent in EMEs in part for reasons similar to those that limit the development of SME loan securitizations – lack of a critical mass of SME bank loans – and in other part due to risk averseness of local investors toward SME credit. As such, it appears that EMEs are starting to use debt funds with other underlying assets, such as reverse factoring, although

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10 Although AIMA does not make this type of estimation, this can be deduced from the data provided in the survey on the average size of borrowers’ EBITDA. We assume that borrowers with EBITDA of less than $10 million are likely small-size SME type companies.
11 The data is based on a project carried out by the German DZ Bank to estimate the market size of loan funds in Europe, primarily through detailed screening of available databases.
12 The targeted volume for all the 95 loan funds was EUR 48.3 bn in 2013, of which about EUR 10 bn, or 20%, was estimated to be invested.
there are only a handful of cases to date, mainly in Latin America.

**Interesting examples of specialized funds come from Peru and Chile.** Peru and Chile have examples of funds dedicated to factoring and reverse factoring. Mexico has a well-established reverse-factoring scheme facilitated by the development bank Nafin but it has not yet been structured in a way that can mobilize local investors through capital markets, though it is a good candidate for doing so. Peru also has recently launched a bond fund that will purchase bonds issued by smaller companies through the alternative market.

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**EXPERIENCE WITH SME DEBT FUNDS: THE CASES OF PERU AND CHILE**

**Compass Fondo de Inversión para PYMEs**

*Compass Fondo de Inversión para PYMEs*, a closed-end investment fund established in 2004, purchases from SMEs account receivables associated with their large customers and sells participation shares to capital market investors backed by the cash flow of these receivables. Hence, the underlying risk of the securities is of these large, creditworthy, sometimes internationally known, firms rather than of the SMEs themselves.

The fund operates with a 2-year term and has been renewed several times since its launch. It started with USD 55 mn in capital and has grown to USD 100 mn, with investors comprising local pension funds, the development bank Cofide, and the *Oficina de Normalizacion Previsional* (ONP). The fund has served over 2500 SMEs and around 32 registered corporations, whose receivables the fund purchases (See *Boletin Empresarial*). The average maturity of the receivables portfolio is 60 days.

The scheme offers important benefits to all the participants. The SMEs are essentially able to transfer their credit risk to their high-quality customers and receive immediate working capital funding at more attractive cost – the implied interest rate is around 13-14% through the Compass factoring scheme, whereas that on working capital loans ranges from 18% to 30% (See *Boletin Empresarial*). Participation is enticing for the large buyers because the fund offers them the opportunity to lengthen their payment schedule from 30 to sometimes 120 days. And capital market investors are able to access the SME asset class at an attractive return – 8-10% annually– without being directly exposed to the SME credit risk.

**BTG Pactual Crédito y Facturas Fund in Chile**

*BTG Pactual Crédito y Facturas*, is a Chilean fund that provides financing to non-bank institutions, primarily factoring companies that, in turn, extend financing to SMEs. Chile has a well-developed factoring industry, supported by recent legal improvements, which have made factoring transactions more reliable and secure. Industry participants include both bank and non-bank factoring companies. The BTG fund focuses on the latter because they face the biggest difficulties in accessing funding, especially of longer-term.

Currently, the fund has four investments: Purchase of receivables from a pharmaceutical company, whose customer base is largely comprised of SMEs; Whole-business securitization of a factoring company; and direct loans to two factoring companies.

The instrument is structured as a listed closed-end fund that offers participation shares to investors who receive monthly dividends based on the income earned by the fund from the different investments. It was established in 2008 with a fixed maturity and has been renewed several times. The return to end-investors has fluctuated over the years but, on average, has been 350 basis points above the Chilean bank deposit rate.

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5 Nafin facilitates an online factoring platform used by SMEs and factors, local financial institutions that purchase SMEs’ receivables. The platform is user-friendly, transparent, promotes competition among factors, and prevents fraud, which is common in factoring transactions. Nafin provides factors low-cost second-tier financing, allowing them to refinance their factoring activities and earn a spread between the rate received from SME suppliers and the rate they have to pay on Nafin loans. See Klapper, Leora. “The Role of Reverse Factoring’ in Supplier Financing of Small and Medium-Sized Enterprises”, World Bank, 2004.


7 Source: Interview with BTG Pactual.
The fund has around 200 investors, including family offices and high net worth investors, and is currently in discussions with pension funds and insurance companies, who have shown interest to start investing in the fund.

To date, the fund has facilitated financing of around $47 million for more than 2000 SMEs.

HMC Capital High Yield Bond Fund in Peru

HMC Capital High Yield is a newly established bond fund in Peru, supported by IFC investment, with plans to invest in local small and mid-size companies with local credit ratings of between AA- and BBB+. Its main strategy is to invest in companies issuing bonds through the Alternative Securities Market (Mercado Alternativo de Valores, MAV), although it is not exclusively concentrating on MAV and plans to also invest in regular public offer bonds of smaller size and lower rating.

MAV is Peru’s alternative public offer regime for companies with maximum S/.200 million (US$ 70 million) in average annual revenues for the last 3 years. It provides simplified disclosure requirements and lower costs to eligible issuers and currently focuses only on debt issues. Since its establishment in 2012, four companies have chosen to issue through this channel. The issuances have mainly been acquired by retail investors, with low appetite from institutional investors. The HMC Capital fund seeks to trigger institutional investors’ interest in these companies by pooling several small bond issues together.

The fund is expected to have up to US$ 100 million in capital. It plans to make around 15 investments over 3 years with an average size of US$ 7 million per investment. Investments will be made in both soles and dollars with two portfolios for each currency; the expected return is 8% in soles and 6% in dollars.

Though the success of HMC Capital is yet to be seen, given its very recent launch, it provides an interesting example from two perspectives. First, by standing ready to buy bonds issued through the MAV alternative market, including through networking with potential companies considering bond issuance, it is helping to stimulate issuance through the MAV, which otherwise has not proven to be viable. Second, by having IFC as a catalytic investor, the fund is able to attract additional investor interest, since IFC’s presence is providing an implicit stamp of approval for the fund’s investment strategy and expectations.

PRECONDITIONS AND CHALLENGES TO USING SME FUNDS IN EMEs

Development of SME funds requires certain preconditions to be in place, some of which may be difficult to meet in EMEs. The main preconditions include the following:

- **Existence of underlying assets** – Two of the funds discussed above – co-origination loan funds and bond funds -- require the existence of a pipeline of underlying assets that are not easy to “produce” in many EMEs. In many EMEs bankable SMEs are scarce and banks are reluctant to take SME risk, thus, there will likely not be sufficient critical mass of SME bank loans, which could be purchased by a co-origination loan fund. Similarly, bond issuances by SMEs are at a nascent stage, not only in EMEs but even in many AEs, making it difficult to identify underlying bond investments for a bond fund. On the other hand credit funds discussed above do not face the problem of a missing underlying asset because they rely on assets (e.g., receivables) that already exist as part of normal business operation for SMEs.

- **Legal and regulatory framework for fund structures** – All the fund types discussed require having an appropriate legal and regulatory framework for funds, especially of the closed-end nature that allow fund vehicles to invest in a variety of assets. In some EMEs such framework is not yet in place or is incomplete. For example, initially when Compass was to be established in Peru, the framework for investment funds did not recognize trade receivables as an acceptable investment asset. Changes in regulations were needed to address this issue. In addition, a proper disclosure framework must be in place.

- **Legal and regulatory framework for underlying assets** – In the case of bond funds, there needs to be in place a framework that allows the issuance of bonds under more streamlined requirements than a regular public offering (e.g., alternative regimes, private offerings, hybrid offers). These types of frameworks are being implemented in some EMEs, though challenges remain for their successful implementation as explained in the note on “Bond Issuances by SMEs.” For credit
funds, such as those relying on leasing and factoring transactions, there is also a need for an appropriate legal and regulatory framework, such as laws related to electronic signature, contract enforcement, and secured transactions among others. This will strengthen and increase security of factoring and leasing transactions, and, as a result, provide greater comfort to end-investors in the funds. For example, the fact that trade receivables constitute an “executive title” that can be enforced through speedier procedures in the judiciary is considered one of the key reasons why the factoring industry has developed further in Chile than in other peer countries. Further, it is considered that the implementation of electronic receivables, expected in the near future, will give a further boost to the factoring industry and to capital market instruments that use them as underlying assets, as the risk of fraud will be materially reduced.

**Investment framework for institutional investors** – Institutional investors are sometimes precluded from investing in certain types of fund structures or underlying assets of funds. Thus, their investment regulations may need to be revised to ensure that targeted investors are indeed able to participate in a given fund vehicle. This was, for example, the case with the Compass fund in Peru, where a regulatory change was needed to allow pension funds to invest in funds that purchase receivables.

**LESSONS FOR DEVELOPING SME DEBT FUNDS**

Collective investment schemes, or funds, bring much value to making the SME asset class more accessible to institutional investors by pooling small SME assets into larger investments and providing diversification, expertise, as well as usually attractive yields. Their development holds significant potential in EMEs, but not all fund types may be appropriate depending on the EME context.

**Co-origination loan funds do not seem a feasible option in most EMEs** because of the lack of a critical mass of SME loans. Measures to develop the necessary pipeline of loans would be similar to those discussed in the SME securitization note, such as improving credit information mechanisms, implementing secured transactions laws, allowing for movable collateral, and establishing movable collateral registries. In larger EMEs, where there may be greater potential for having a pipeline of bankable loans, co-origination or specialized loan funds could be a more viable option. For the former, it would be important to ensure that proper incentive structures are in place, including ‘skin-in-the-game’ arrangements. Multi-originator structures could also be explored, as a critical mass of loans is more likely to exist across several banks instead of a single institution.

**Reverse factoring funds are particularly relevant for EMEs**, where there is high risk-averseness among institutional investors toward SME risk, because of the relatively short-term nature of the credit assets (i.e., maturity of receivables) provided through factoring and, in the case of reverse factoring, no direct exposure to SME risk. However, ensuring safe and fraud-free factoring transactions are key to instilling investor trust. This could be achieved through appropriate laws, as mentioned above, as well as technological solutions (e.g., electronic platform).

**SME bond funds could play an important role in certain EMEs**, especially where supply-side measures to help attract SME issuers have already been implemented, namely some type of an alternative issuance regime that facilitates the issuance process for SMES. In fact, in countries with dedicated SME issuance regimes, i.e., alternative markets, but a limited retail investor base, bond funds can be instrumental in jumpstarting issuance in these markets and making them more viable, as was seen in the case of Peru above. In other countries, alternative markets could be developed in tandem with bond funds, that is, designed from the beginning with funds as the main target investors.

**Finally, public or multilateral support may be needed**, at least in initial stages, to provide incentives or play a catalytic role to attract investors and bond issuers, in the case of bond funds. Public support may include partial guarantees for the fund’s investments, seed investment in the fund like the Business Finance Partnership fund in the UK, tax incentives for SME bond issuers or investors, and education/training about bond issuance for potential SME issuers. Multilateral support would most likely be in the form of a strategic investor in the fund to help crowd in domestic investors that may feel apprehensive about investing in a new vehicle.
Securitization of SME Loans

Ana Carvajal, Lead Securities Markets Specialist, F&M GP; James Walter Hammersley and Jeffrey David Anderson, both consultants F&M GP

DEFINITION

SME loan securitization is a financing technique that allows the transformation of SME loans which are illiquid in nature, into tradable securities that can be bought and sold in the capital markets. Securitization allows the creation of a secondary market for SME loans, whereby a bank or lender (the “originator”) extends loans to SME companies (“primary market”), bundles them in a pool (“portfolio”), and sells the portfolio to capital market investors through the issuance of securities by a special purpose vehicle (SPV). The securities are backed by the loan portfolio (Asset Backed Securities, ABS). The asset-backed securities, classified by risk categories, represent tranches of the underlying portfolio.9

POTENTIAL BENEFITS

The benefits of SME securitization for banks (and specialized lenders) and investors are similar to those of securitization in general. Securitization provides banks (and specialized lenders) with an alternative source of funding in cases where they have either limited access to capital markets’ refinancing tools or unsecured bonds can only be sold at high cost. In addition, in the case of banks it potentially allows them to achieve economic and regulatory capital relief. From an institutional investor perspective, SME securitization offers investors access to assets to which would otherwise not be available. This can be attractive from a risk-return as well as from a portfolio diversification perspective.

The most important benefits of SME securitization are for the SMEs themselves, and thus, potentially for economic growth. SME securitization could have a multiplier effect in the level of SME lending. As banks offload the loans, the same capital base could be used to generate additional loans.

9 This Note focuses on true sale/funded securitizations. An alternative to them are “synthetic securitizations” which combine traditional securitization techniques with credit derivatives. In this case the credit risk of a selected reference portfolio of loans (but not the loans themselves, which remain on the balance sheet of the originator) are transferred to a special purpose vehicle that places notes (Credit Linked Notes, CLNs), classified by risk categories, in the capital market.
USE IN AEs

SME loans have been securitized in the United States and Europe for many years. However, SME loan securitization remains a very small part of the overall securitization market, accounting for just 2 percent ($34bn) of US asset backed securities outstanding, and 7 percent (€105 billion) of total European securitization outstanding. Furthermore, partly on account of the contraction in European loan growth, new issuance (i.e. capturing flows) has tailed off substantially in Europe since the peak of €90 billion in 2007 (Figure 1).

Figure 1. Annual European SME Securitization Issuance

The SBA securitization program has had a leading role in SME securitization in the United States. SBA issues securities which are backed by the guaranteed portion of loans given by lenders to small businesses. The securities have the full faith and credit of the U.S. government. As a result they are very attractive to institutional investors. SBA volume in recent years has reached record levels in terms of the total amount lent (loan volume exceeded US$ 19 billion in 2014) and number of participants involved. Other SME securitization is in its early stages, but is expected to further expand at a growing pace due to the participation of more non-depository lenders in this space.

Pre crisis Germany and Spain had the most active programs of SME securitization in Europe. The German SME securitization model was developed by KfW which acts as an intermediary, providing a centralized platform and defining the selection criteria of the loans. They are structured as synthetic securitizations, whereby only the credit risk is transferred. The originator retains a first loss piece while the remaining tranches are sold to investors. Securitizations in Spain are mostly true sale, and funded. SME loans are securitized via close-end funds which issued securities. The senior tranches have the guarantee of the Kingdom of Spain. In both cases pre-crisis the securities were bought by institutional investors.

Post crisis Italy and peripheral countries such as Greece and Portugal became more active, although the volumes correspond to a very small number of underlying deals (BofA Merrill Lynch, 2014). The majority of deals were retained for repo funding with the ECB. Synthetic securitization nearly disappeared, as the main motivation for structuring SME transactions was funding rather than capital enhancement needs.

Source: Association for Financial Markets in Europe, IMF Staff

[1] Data for 2014 are as at Q3, annualized. Sample includes countries in the euro area, UK, Russia and Turkey.
SME SECURITIZATION PROGRAMS IN AE

**United States**

The US Small Business Administration (SBA) was created in 1953 to further the interests of the small business community and to promote competition in the marketplace. As part of its mission, the SBA, under Section 7(a) of the Small Business Act provides loans and loan guarantees to small businesses. Based on such authority, the SBA implemented a scheme that provides a partial guarantee on almost $20 billion annually in loans to small businesses. Businesses must be for-profit and meet the SBA’s definition of small. The maximum loan size is $5 million and the guarantee percentage ranges from 50% to 85%, averaging about 72%. Loans may be used for machinery, equipment, working capital and real estate and typically have floating interest rates based on the Prime Rate or Libor. Tenors up to 25 years are available for real estate loans.

In 1985 the SBA started securitizing the guaranteed portion of the loans; whereby the SBA issues securities which are backed by multiple guaranteed portions of loans. In addition to the credit guarantee of the loans, the securities issued by SBA have a timely payment guarantee. Further, the securities have the full faith and credit of the U. S. Government. As a result, investors did not have to worry about payment or perform due diligence on the creditworthiness of the borrowers or lenders. This reduced the investor’s purchase costs and encouraged more securities brokers to sell the product. As the loan scheme and securitization program grew, many loan officers began to specialize in SBA lending. SBA continued to improve the efficiency of the program and delegated significant authority directly to lenders. The program has continued to grow and loan volume exceeded $19 billion in 2014.

The first securitization backed by the unguaranteed portion of SBA loans took place in 1992. It was only for loans originated by non-banks, or non-depository lenders. In 1997, banks were allowed to securitize the unguaranteed portion of the 7(a) loans. There is no government guarantee on these transactions. However, SBA required that the lender retain some of the risk in the deal. The amount of the retention was related to the performance of the lenders portfolio. Overcollateralization was used as a credit enhancement. This process was mainly used as a financing tool by nonbanks lenders that did not have a deposit base.

**Spain**

In 1998–1999, the Spanish government established the FTYMPE (Fondos de Titulizacion de Pequenas y Medianas Empresas), a program to facilitate SME securitization. The mechanics of the program are simple: the Treasury commits to guarantee certain tranches of an issuance of a securitization fund, provided that it holds in its portfolio a minimum percentage of bank loans to SMEs. In return for the liquidity gained through the sale of the SME loans, the originator commits to reinvest part of this liquidity in SME financing.

The participating banks must sign an agreement with the Minister of Economy and Finance; assuming certain commitments, in particular: (i) at least 50% of the assets transferred must be SME loans; (ii) financial institutions transferring assets must reinvest at least 80% of the proceeds into new SME loans, and (iii) the reinvestment must take place within 2 years, with at least 50% happening in the first year.

For a portfolio of such characteristics, the Treasury guarantees 80% of the securities with a rating of AA2 or higher. If the funds required to repay at any point are not available, the amount is paid by the Spanish treasury until redemption. However, it would take at least three months for the government to fulfill this shortfall. As a result, FTYMPE enters into an agreement with the bank for liquidity. At any given point, FTYMPE can raise up to €13 million to fulfill the shortfall. The bank will repay FTYMPE as soon as it receives the funds from the Spanish Treasury. The bank will sell its SME loans at par to FTYMPE. To finance these loans, FTYMPE issues notes in accordance with the ratings. At any point the originator as equity investor has to maintain a balance of 3.3% of the initial balance of the notes and 6.6% of the notional payment or 1.5% of the outstanding balance, whichever is higher.

As with Spanish securitization in general, multi-originators are common. Pre-crisis originating banks retained the higher risk equity tranches. Since 2008, originating banks have retained the bulk of the senior tranches (on sharply reduced new issuance) to use as collateral for refinancing from the ECB. Since 2000, €50,640 million have been issued, making it possible to reinvest more than €40,512 million in new credits for SMEs. Though, volumes have declined since the crisis.
USE IN EMEs

The SME securitization market is at a nascent stage in EMEs. Securitization markets are still at a developmental stage in most EMEs, although in the larger EMEs (such as China and India) securitization has experienced considerable growth during the last decade. The SME segment is at an even earlier stage. SME securitization transactions have taken place in many EMEs, including for example Bangladesh21, and Malaysia22, but in most cases they have been one-off transactions. Only in a handful of the larger EMEs, such as Korea and India, SME securitization has been used more consistently. In India, for example micro finance and SME securitizations reached 13% of total securitization activity in 2013 and 16% in 2014. In China the first SME securitization took place just in 2013. It was part of Alibaba’s small business securitization program. Alibaba has been making small and micro business loans by taking advantage of its vast internet access. As of 2nd quarter 2013, it was reported that Alibaba has accumulated more than 320,000 small and micro enterprises loans. There are a few interesting aspects of this securitization program that are worth noting:

Assets are replenishable over ten periods in the sense that new loan assets can be purchased and securitized under this same program as old ones are repaid and retired in each period. The expectation is to issue 200-500 mm yuan for each period totaling about 2-5 billion yuan for the entire program.

CHALLENGES TO SME SECURITIZATION IN EMEs

SME securitization in EMEs faces a complex set of challenges. A few challenges are more unique to EMEs, stemming mainly from the different stage of development of their securitization markets, and more generally their fixed income markets compared to AEs. However, some of them are directly related to the asset class and therefore are common to both AEs and EMEs, although the challenges might be more pressing for EMEs.

CHINA SME SECURITIZATION

China’s securitization market has grown considerably over the last five years. From 2013 to 2014 securitization activity grew from $3 billion to over $4 billion23. However, the first SME securitization took place in 2013. It was part of Alibaba’s small business securitization program. Alibaba has been making small and micro business loans by taking advantage of its vast internet access. As of 2nd quarter 2013, it was reported that Alibaba has accumulated more than 320,000 small and micro enterprises loans. There are a few interesting aspects of this securitization program that are worth noting:

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- Challenges related to the underlying assets
  - Lack of bankable SMEs: For many EMEs the lack of bankable SMEs is the key challenge affecting the development of SME securitization markets. This stems from a complex set of issues, including the level of informality and poor management of the companies, but also the lack of reliable and complete credit information on them.

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21 BRAC issued a securitization backed by loans it made to micro borrowers. The transaction was completed in 2006 and, performed well. While this transaction seems successful, there does not appear to be any additional activity since then.
22 In 2007, a 600,000,000 Ringgit (approx. $175Million U.S.) synthetic securitization of SME loans was closed by Maybank. Although the goal was to establish a model to finance SMEs, there was no evidence of follow on transactions.
• **Critical mass of loans at individual bank level:** A second challenge, related to the first one, is the lack of a critical mass of SME loans at individual bank level to make the securitizations financially viable. Due to their complex nature, SME securitizations are characterized by high costs; thus critical mass is needed to lower the costs. However, in many EMEs individual banks do not possess large SME-pools.

• **Heterogeneity of SME loans.** SME loans are, in principle, less homogenous than residential mortgages (with regard to size, legal forms, collateral etc.) and the underwriting criteria are less standardized. This makes it more difficult to assess default risk and potential recovery values.

• **SME loan maturities.** SME loans are typically short-dated and so not well suited to institutional investors with long-term liabilities like pension and insurance funds.

• **Challenges related to the enabling environment for securitization:** The growth of securitization markets in larger EMEs suggest that many of them might have managed to put in place the basic enabling environment for securitization. However, in the remaining EMEs securitization markets have experienced more limited development. As a result, critical aspects of the enabling environment which support securitization markets might not yet be fully in place or have not been fully tested. Those aspects relate to:
  
  • A robust legal framework for securitization, with clear rules regarding eligible assets and robust special purpose vehicles that are bankruptcy remote.
  
  • A stable regulatory framework that provides guidance to issuers and investors regarding exactly how the securitization will be treated by banking and securities regulators. This includes:
    
    • whether a securitization is a true sale or a financing;
    • exactly how much capital is necessary to support a lending portfolio if the assets are securitized;
    • any restrictions regarding who may own a portion of the transaction or how much may be owned by one investor;
    • a level of transparency that is satisfactory to issuers and investors. Overall, one of the key lessons from the crisis is the need to ensure that investors are given sufficiently granular information about the portfolio of assets and its performance (i.e. data at the individual loan level).
  
  • A clear definition of a retention requirement to insure that the incentives driving the issuer are designed to provide optimum long term performance of the transactions. The need for retention requirements has been another key lesson from the crisis.
  
  • A stable tax framework, which provides favorable regulatory treatment to the transfer of assets, and clear guidance on the taxation of interest paid on securitized transactions.
  
  • Access to reliable trust services for payment and collateral handling. The trustee must have a good financial standing and be extremely unlikely to enter bankruptcy.
  
  • A cadre of professional accountants, auditors and attorneys with specialized expertise in securitization issues and credit rating agencies.

• **Challenges related to the legal and regulatory framework applicable to institutional investors:** The appetite of institutional investors for SME securitization instruments is largely influenced by the prudential framework applicable to them. In some EMEs, the rule-based investment frameworks applicable to pension funds are overly prescriptive and impose significant restrictions or even prohibit investment in “alternative assets”, which depending on the country might include asset backed securities. Further in many EMEs there are also minimum rating requirements that would create the need for credit enhancements. In some EMEs these limitations on eligible assets apply also to insurance companies. Further, as EMEs progress in the implementation of solvency frameworks for insurers there would be the need to ensure that they are properly calibrated. For example, the capital charges under the EU Solvency II Directive for insurers investing in securitization transactions are higher than those for other assets with comparable risks. Thus, there are concerns that this type of regulatory treatment might affect investors’ appetite for these instruments. Initiatives such as those in the EU to provide favorable regulatory treatment to high quality securitizations could mitigate this type of challenge.\(^4\)

• **Structural challenges:** Finally there are elevated upfront costs associated with securitization, which include setting up technology systems to handle data related to the underlying assets, and costs related to pooling, legal documentation, due diligence, credit ratings and in some cases credit enhancements.

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\(^4\) See Aiyar, Shekhar et al. "Revitalizing Securitization for Small and Medium Enterprises in Europe", International Monetary Fund Staff Discussion Note SDN/15/07, May 2015
LESSONS TO DEVELOP SME SECURITIZATION MARKETS IN EMEs

In the majority of EMEs, but in particular the smaller ones, the development of a SME securitization market is not a feasible proposition, at least in the short to medium term. The lack of a sufficiently robust pipeline of bankable SMEs prevents these markets from developing. Thus in such jurisdictions the key to improving SME financing should focus more on measures to increase the availability of banking and asset backed lending, which in turn could have a positive effect in SME securitization. Such measures mainly relate to improving the credit information available, ensuring that a robust framework for secured transactions is in place, as well as an appropriate insolvency regime, as detailed below. In addition, experiences indicate the benefits of developing guarantee loan schemes. The SME asset class is riskier both due to the lack of credit information as well as the nature of the SME companies themselves. As a result, the existence of a public guarantee program might become a critical element to align the risk appetite of banks and encourage them to increase their SME lending (see box on experience of U.S.). However, it is important that those guarantee programs are carefully designed to ensure their sustainability and that proper management of contingent liabilities is in place.

THE IMPORTANCE OF CREDIT INFRASTRUCTURE FOR SME FINANCING

Credit information
Credit reporting systems are an essential tool to address the SME financing gap as they help to address the problem of asymmetry of information. While credit bureaus cover with a great level of granularity credit information for consumers (individuals), they frequently do not provide information on SMEs. Credit insurers, credit rating agencies, commercial credit reporting systems and credit registries may serve as an alternative and provide inputs on SMEs to those parties that do provide financing. The benefits of CRS depend largely on the size of the SMEs. For the smaller SMEs, which usually represent the bulk of SMEs in a country, reform efforts should be oriented to allow non-traditional typologies of data to be shared with credit bureaus. These data includes for example data on payments to mobile telephone companies, utilities, and public data. In the past few years these data has proved important to build a credit history for those who do not have it (the “informal”, non-bankable, micro/SME). For the larger SMEs, CRS such as SME rating systems would be a complementary source of information that could potentially be used also by capital markets as an additional tool to assess creditworthiness.

Collateral lending
The inability to use a firm’s most valuable assets as collateral is among the top reasons for difficulty in accessing finance. According to the World Bank’s Enterprise Surveys, assets owed by any given business are typically 75% movables (inventory, equipment, farm products, accounts receivable and intangibles) and only 25% are real property (land or buildings); conversely, collateral required by lenders is typically 80% real estate and only 20% movables. A crucial tool to better balance the assets SMEs possess with those that banks can accept as collateral, is to reform the legal regime governing secured transactions and collateral registries. While real property is widely accepted as collateral for the extension of new loans, the use of movable collateral (such as inventory, accounts receivable, IP rights, companies’ shares, livestock, crops, equipment, and machinery) is restricted in many jurisdictions by non-existing or outdated secured transactions laws and registries. Thus, modernizing their secured transactions framework should be a key priority for EMEs.

Reforms in this area could have transformational effects in the MSME financing space, as recent examples illustrate. In China, the introduction of the secured transactions reform in 2007 helped to increase movable asset financing by 21 percent per year (by number) and 24 percent per year (by volume) from 2008 to 2010, compared to no growth from 2006 to 2008. Further from the registry launch in 2008 to June 2011, more than USD $3.5 trillion was financed using movable assets pledges, of which over $1.09 trillion corresponded to SMEs loans. In Colombia, in less than one year more than 100,000 loans secured with movable collateral have been registered in the movable collateral registry, of which 5,000 loans correspond to MSMEs, compared to a few hundred loans for SMEs prior to the reform. Finally, developing modern secured transactions systems can be cost efficient. In China, in the first three years after the reform was introduced, more than $400,000 of financing was generated per every dollar invested into the project.25

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Insolvency
Implementing a robust insolvency system that promotes the reorganization of viable enterprises and gives honest entrepreneurs a second chance is also critical to improve SME’s access to finance. A reorganization-oriented insolvency regime plays a crucial role in mitigating investor and creditor risk, which in turn contributes to improved access to credit and lower cost of credit, as well as to a more stable financial system. As a result of reorganization procedures, creditors are willing to extend more credit, debtors are provided an opportunity to stay in business and employees keep their jobs.

Evidence from previous work in this area suggests that reforming an insolvency regime can help lower interest rates, making credit more affordable especially for SMEs. For instance, research concluded that in Italy, the 2005 bankruptcy law reform that deeply reformed the liquidation procedure led to a decrease in interest rates. In particular, firms with higher numbers of bank creditors saw the most pronounced reduction in interest rates due to the enhanced coordination provided by the bankruptcy law. In Brazil, a study of the 2005 bankruptcy law reform reported a statistically significant increase in the Brazilian private credit market. At the firm level, the authors reported a 10% to 17% increase in total debt and a 23% to 74% increase in long-term debt.

For the larger EMEs, with the potential for a pipeline of SME loans, the development of SME securitization markets is an option.

The majority of EMEs did not face the reputational problems that AEs did in connection with securitization. A key reason was the fact that securitization markets were at an earlier stage. Structures were simpler and business models such as the “originate to distribute” model had not yet developed. There were exceptions, particularly in the larger EMEs, such as Mexico—which had developed a housing finance model that shared some of the features of the US housing market—and Brazil.

Yet there is a common concern about the need to ensure that the securitization markets develop under a solid footing, with structures that are as simple, transparent, and robust. In this context, EMEs that want to mobilize institutional investors to invest in SME securitization, would need to ensure that a robust framework is in place, but also that the characteristics of the instruments are aligned with the risk/return appetite of such investors. The experience from AEs indicates that the latter will most probably require guarantees. In sum, reform efforts will likely need to address both supply and demand side frictions if they are to mobilize capital toward the asset class.

- **Enabling environment:** The challenges and specific steps necessary to address gaps in the enabling environment vary from country by country. In general, in larger EMEs any need for reforms would stem more directly from the lessons from the crisis, in particular the need to improve disclosure to investors and impose retention requirements. For the remaining EMEs the tasks ahead are broader. As a first step EMEs authorities should conduct an assessment of each of the elements identified above and determine the status in their respective countries.

- **Guarantee programs:** Guarantees can help to align institutional investors’ appetite, in a similar fashion as for banks. In countries where public guarantee programs already exist for individual loans, and where such programs have proven to be successful and sustainable, the key might lie in connecting existing programs with capital markets (see the experiences of Spain, for example). Avoidance or at least reduction of moral hazard problem is critical. To address the potential moral hazard problem, the roles of the public guarantee organizations should be clearly specified and performance must be regularly evaluated and reported. From a policy standpoint, such support should be conditional upon ensuring “additionality”, i.e. extending new loans to SMEs – so that SMEs effectively benefit from the support given to the SME securitization transactions. However, it is important that there be adequate management of contingent liabilities for the government. To support the development of a healthy SME securitization market, the guarantee program should establish conditions for the loans themselves, the information to be given to investors and the structures used, as further discussed below.

- **Simple and transparent structures:** The use of plain vanilla structures, easy to understand should be another element of the guaranteed program (for example no multiple securitizations like CDO of CDOs/CDO of ABS). Further, ongoing information,

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in particular on loan performance should be given to investors. The latter should be a condition for public support, even if the securities are placed via private placements.

- **Further standardization of SME loans:** In line with existing proposals for other types of underlying assets, a healthy development of SME securitization should be accompanied by a definition of certain minimum standards that SME loans would need to meet. Meeting such definition would be a key element of the public guarantee program, as is the case for the KfW.

- **Lengthening the duration of SME loans** and thus SME securitizations could make the asset class more appealing for liability-driven institutional investors like defined benefit pension funds. However this might be a long-term goal.

- **Centralized platforms:** The development of centralized platforms and/or structures that allow the inclusion of loans from multiples originators would help address problems of critical mass at individual bank level. It is important to mention, however, that the creation of centralized platforms is a complex task.

- **Capital charges:** this is a task for AEs and EMEs as well. There should be proper calibration of the prudential frameworks applicable to different types of intermediaries, in particular such frameworks should make proper distinctions between different asset classes and/or tranches (i.e. high quality loans or senior tranches should in principle have a better capital treatment). This will be key to aligning institutional investors’ appetite for this product in EMEs.
SME COVERED BONDS

Simon Walley, Lead Financial Sector Expert, F&M GP with collaboration from Richard Kemmish, consultant.

DEFINITION

Covered bonds are debt securities issued by a credit institution that are backed by a dynamic cover pool of high quality assets. Investors have double recourse to the issuer and to the cover pool, and thus the covered bond remains an on-balance sheet instrument. Issuers can be traditional deposit taking banks or in some cases specialized mortgage lending institutions primarily reliant on covered bonds for their funding. A key feature though is that the issuer has to be a regulated institution meeting minimum governance standards and capital adequacy requirements.

In general, covered bonds are issued under a dedicated legal framework. The covered bond laws provide for minimum quality standards for the collateral, with loans in a cover pool having to be exchanged for performing assets should the original ones become impaired. The existence of such requirements provides investors with confidence that the bonds are issued in a uniform way and adhere to strict standards. This in turn creates a pool of bonds which are broadly homogenous creating a deep and liquid secondary market which helps reduce overall funding costs.

POTENTIAL BENEFITS

Covered bonds have been a strategically important addition in the funding options available to financial institutions, in particular mortgage lenders in Europe. They have provided the market with a long term funding tool with cost efficient performance on the issuer’s side and a stable and safe long term, liquid investment on the investor’s side, contributing significantly to the creation of an efficient housing market. They also possess other advantages for investors. They usually come as bullet bonds, with less risk of adverse selection compared to securitizations. Investors usually receive bullet or simple amortizing structures, which are easier to understand and manage than securitizations. With the collateral still on the banks’ balance sheets, adverse selection and agency problems are lower than under securitization. Further, EU-based banks like their lower capital charges and preference they receive under the Liquidity Coverage Ratio (LCR). Insurance companies like the more lenient treatment that covered bonds receive under Solvency II compared to other private debt.

Covered bond collateral is not limited to the country of issuance. For instance, some German public sector covered bonds contain Japanese public sector loans.

This feature has recently been taken a step further through the Covered Bond Label initiative which aims to have a broader international standard, creating a truly global pool of investable assets which investors can fund with confidence.
CURRENT USE IN AES AND EMEs

Covered bonds originated in Germany and Denmark, and have extended throughout Europe and are currently one of the key components of European capital markets. With over EUR 2.58 Trillion outstanding at the end of 2013, covered bonds continue to play an essential role in bank funding strategies or the European banks, in particularly, from a mortgage market perspective, the amount of outstanding mortgage covered bonds is equivalent to around 20% of outstanding residential mortgage loans in the EU. The EUR 695 billion issuance and arrival of 30 new issuers during 2011 evidence the ability of the asset class to provide essential access to long-term capital market funding.

There is growing worldwide appetite for the asset class with market stakeholders having obtained, or pushing for, covered bond legislation in countries as diverse as Australia, Brazil, Canada, India, Japan, Mexico, Singapore, South Korea and the US. A key driver in this development is the fact that the asset class constitutes a long-term funding tool which ensures lending to the real economy.

The investor base of covered bonds has been dominated by investors who prefer ‘safe’ assets which trade with a positive spread to sovereign bonds. Up-to-date data on the investor base are not available. A survey conducted by the Association of Financial Markets in Europe of European covered bond investors from 2009 shows asset managers owning about half outstanding covered bonds, with banks and broker-dealers owning another 33 percent of the outstanding issuance. The preferential treatment newer regulations (Basel III and Solvency II) afford to covered bonds should increase the share of banks and insurance firms in the investor base.

USE FOR SMEs ASSETS

There have been very few experiences with the use of SME loans as the underlying assets for covered bonds. A key reason for this relates to the fact that SME loans are not currently included as an eligible asset for purposes of a preferential capital treatment in the corresponding EU regulations. Still, interesting experiences can be found in Germany and Italy.

In Germany, Commerzbank issued covered bonds backed by SME loans in 2013. However, the motivation behind the structured SME covered bond program from Commerzbank had more to do with Commerzbank’s own situation having recently sold its pfandbrief entity, leaving it with no other way to access the covered bond market. Since then Commerzbank has gained an issuing license for mortgage pfandbrief in its own name. The rationale for the issue in terms of funding was unclear given that neither the issuer nor the German mittelstand sector were struggling for liquidity at the time. This aside, the transaction provides

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20 Eighty percent of covered bonds are mortgage covered bonds, the main part of the balance being public sector covered bonds.
21 However the European Covered Bond Council (ECBC) has established a working group to explore the potential of Covered Bonds as a funding instrument for new collateral classes.
Some helpful precedents for both structuring and pricing. In addition, loans to SMEs are currently included in pfandbrief cover pools, in two different ways. Those that are secured on real estate are eligible for mortgage pools, some of these even in residential pools, to the extent that the entrepreneur has put up their house as collateral and/or it is mixed use (flat above the shop) property. Secondly, some loans to SMEs are insured, in particular by KfW. As this is ultimately German government risk these loans are eligible for public sector pfandbrief.

Most pragmatically, the Italians have copied their existing covered bond technology to create a parallel - and crucially, separately branded product for SMEs. The so-called Obbligazioni Bancarie Collateralizzate (OBC) are able to include a wide range of assets in their cover pools including SME loans, corporate bonds, commercial paper, shipping loans, lease and factoring receivables, as well as ABS tranches backed by the above assets. This is a work in progress. One of the reasons for this approach may be that Italy has a large SME sector together with an extremely sophisticated credit rating system for SMEs. With the right use of technology, this could potentially help create a very transparent cover pool in terms of its risk profile. However, those bonds are not subject to the same regulatory requirements and potential backing by the Italian central bank as traditional covered bonds are. They also do not enjoy the same preferential rights under the EU’s banking and insurance regulations as bonds backed by mortgages, public sector, ship, or airplane debt do.

Turkey is one of the EMEs that has recently enacted covered bond legislation. A key feature of the Turkish covered bond framework is that it includes SME loans as eligible assets. One bank has already made use of this framework and placed a few issuances in the market. Investors tended to be public sector entities and multilateral development banks which may have a different, less commercial view of the ‘risk’ characteristics of the assets. If the bonds were sold more widely on the general market the fact that these covered bonds were from Turkey would be the most important point in the pricing and credit analysis making the asset class itself a secondary consideration.

**KEY CHALLENGES FOR THE DEVELOPMENT OF SME COVERED BONDS IN EMEs**

**From the structuring side**

- **Critical mass of underlying assets:** The funding advantage which covered bonds can offer over alternative forms of long term finance is often marginal and is in part derived from the high level of liquidity in the instrument itself. This is achieved by regular issuance which helps to drive an active secondary trading market. A key challenge to the use of this instrument for SME financing in EMEs is that origination of the cover assets (SME loans) is often not sufficient to allow for large volumes of issuance. This means that the liquidity bonus associated with covered bonds cannot occur which weakens their competitive advantage versus more traditional funding methods.

- **Capital charges:** Because covered bonds are an on-balance sheet asset, banks that raise funding this way still bear the full capital charge associated with the loans they are funding. Under the new Basel III framework, new capital charges will be introduced to reflect any maturity mismatches in a bank’s balance sheet. This will increase the cost of long term funding and potential reduce the attractiveness of maintaining long term assets on the balance sheet. Securitization which previously was a way of removing credit risk from balance sheets until changes in global regulations, could again become a regulatory arbitrage tool used to manage liquidity risk.

The second issue worth considering is that under the European Capital Requirements Directive covered bonds do benefit from a preferential capital treatment for the holders of the bonds. Given that a large proportion of investors are banks subject to capital requirements, it makes covered bonds an attractive investment which requires relatively low levels of regulatory capital due to the low loss given default and probability of default used in the credit risk calculations. This feeds through to cost of the bonds and the margin charged over the risk free rate, making them more competitive versus other forms of funding. At present though, this treatment would not extend to bonds where the cover asset is SME loans.

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32 As Turkey is not yet bound by the EU Directives, the conformity with the ECBC definition of eligible assets has not been an issue of concern.
33 Responses to the European Commission Green Paper on Long-Term Financing of the European Economy, European Commission, January 2014
• **Cover Matching Principle:** One of the core elements of a covered bond structure is the elimination of as much risk as possible by matching the cover pool characteristics to those of the bond. Housing finance which uses long term (up to 30 year loans) on an amortizing basis, provides a good mirror for long term bonds although not a perfect one. Some systems such as the Danish Covered Bond model do aim for a perfect mirror, but generally the bonds are issued for a shorter period than the mortgage loans. This does create some mismatch issues and some refinancing risks. In terms of maturity it is possible that SME loans which are unlikely to be quite as long term as mortgage loans may actually offer a closer maturity match. However, SMEs loans will have much less predictable repayment patterns and therefore difficult to mirror cash flows. This however is not insurmountable and could in some cases create an advantage in terms of cash flows where on some occasions traditional covered bonds can struggle.

From the investors’ side

• **Piercing Sovereign ceiling?** - In many regards the asset class is less important than the geography. The sovereign risk would be the key determinant of pricing rather than the detailed characteristics of a particular structure. The bonds will be priced according to the local environment and risk rating almost regardless of the underlying portfolio, structuring, or safeguards such as cover pool monitors etc. So in that sense opening up the eligibility of cover assets to other collateral classes may not be a major issue.

• **Different investors’ needs** – There are broadly two types of investors who might be interested in emerging market covered bonds – (i) traditional covered bond investors looking for higher levels of return and (ii) EMEs investors looking for returns but also managed risk. This latter group may be difficult to attract as covered bonds will not offer a substantial uptick versus government debt, and in some cases may be negative. Bank treasurers (in the EU) on the other hand will not invest as the bonds will not be HQLA for LCR purposes under Basel III.

Local bond investors looking for alternatives to government fixed income - In terms of developing local capital markets, local currency investors will not have the same asset class prejudices and the government can define covered bond eligibility however it likes (if it chooses to put in place buy-side regulation). In many EMEs, the options for institutional investors are really very limited. For fixed income there will be some government debt although it is not always traded, so having a new fixed income asset class could be very welcome, regardless of structuring issues.

**LESSONS: POSSIBLE AREAS FOR FURTHER EXPLORATION**

• **Creating a new instrument** – One of the strengths of the covered bond system is founded on the underlying value in the ‘cover pool’. This is ensured through rigorous standards and regulations to ensure that it provides adequate cover throughout the life of the bond. One of the key features of such regulations is precise definitions of eligible collateral. This helps to ensure the heterogeneity of the cover pool, so that investors are comfortable with the asset quality without needing to do extensive due diligence on the underlying asset such as in the case of a securitization.

A common argument against new asset classes being included in eligibility criteria for covered bonds will be the quality dilution impact on the overall product. Limiting the types of assets and maintaining the utmost standards is deemed to have built a brand over centuries which should be preserved. Any dilution would impact the whole covered bond family, reduce liquidity, increase spreads, and reduce investor appetite for the product they know and trust. Therefore, including SME loans as part of the eligible assets for covered bonds might not be the right way to approach the issue. SME loan will have different repayment profiles, risk characteristics, structuring requirements to mortgage loans.

Rather than trying to make SME fit the current template, a more innovative approach should be considered using a new instrument which uses some of the undoubted qualities of covered bonds but also uses the benefits of SME finance loan assets to best advantage. The Italian OBC is a good example of a new approach using comparative advantages such as a good credit scoring system for SMEs.

• **SME loans backed by real estate** – In practice many loans to SMEs are actually already backed by real estate either in the form of the work premises or the living accommodation of a self-employed entrepreneur. Certainly in many EMEs, any form of term financing has to be secured in some form. Using loans which have real estate collateral could provide suitable cover. The area which may require more work is on the cash flow of the loans. Unlike a traditional amortizing mortgage, a business may need greater flexibility in its credit with provisions for drawing down or repayment. Having such a credit facility backed by real estate collateral could provide security for funding but will require some analysis in terms of matching of cash flows of the loans versus payments to bond holders.
• **Improved SME credit information systems** – A major difficulty in using SME loans as part of the cover pool is the lack of good quality data on the credit risk for the underlying loans. Improving credit scoring systems and availability of information could help remove some of the risks reducing credit risk charges and increasing investor appetite.

• **SME Centralized Covered Bond Issuance Platform** – Creating a pooled issuance platform can help create the necessary volume, reduce issuance costs and also mutualize issuer counterparty risk. Issuance is no longer constrained at the institution level but is aggregated at the sector level. This has many benefits in terms of costs, logistics, risks and regulation. However, the creation of such platforms is a complex task. As a hypothetical example, an organization such as SIDBI in India could play a similar role to the National Housing Bank which acts as a mortgage liquidity facility. It is likely that some forms of public guarantee would be necessary but given that the bonds would be backed by collateral in the form of loans, this may be a form of limited guarantee.

• **SME Covered Bond Guarantee Facility** – Another potential approach could be modelled on the way KfW underwrites certain bond issuances which can then be repackaged into Public Sector Covered Bonds. This type of approach could be used for SME covered bonds. Such a guarantee facility could be established as a partly commercial venture which would charge a premium for coverage, with part of the guarantee also provided by a public sector entity. This could be in the form of a national government or development bank, or a regional/multi-lateral development institution.