

# What's Happening in the Missing Middle?



## LESSONS from Financing SMEs

- EDITORS -

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# FOREWORD



**S**mall and medium enterprises (SMEs) are the economic backbone of virtually every economy in the world. SMEs represent more than 95 percent of registered firms worldwide, account for more than 50 percent of jobs, and contribute more than 35 percent of

Gross Domestic Product (GDP) in many emerging markets. Moreover, the contribution of SMEs to GDP actually increases as economies develop – with SMEs in the developed world contributing well over 50 percent of GDP. SMEs generate most of the new jobs that are created; they help diversify a country’s economic base; they promote innovation; they help deliver goods and services to the bottom of the social pyramid; and they can be a powerful force for integrating women and youth into the economic mainstream. And appropriate financial allocation decisions – that allow productive SMEs to expand and become large firms, distressed but productive SMEs to restructure, and unproductive SMEs to exit so that their resources are reallocated to growing firms – are critical to generate economy-wide benefits.

Yet despite these economic, social and political benefits, these enterprises remain significantly underserved by financial institutions. In investment-climate surveys around the globe, the difficulty of obtaining financing is usually one of the top three constraints on doing business that are identified by SMEs – and, in several regions, access to finance is the single most important constraint. This finding is supported by research that has calculated that the credit gap that formal SMEs confront is about \$1 trillion. When informal SMEs are taken into account, that gap widens even further, to around \$2.6 trillion.

In an effort to bridge that financing gap, the World Bank Group works across a number of its Global Practices – and in conjunction with the International

Finance Corporation’s Financial Institutions Group (FIG) and Cross-Cutting Advisory Services – to provide support to SMEs. In addition, because the constraints faced by SMEs are not all financial, close coordination with our colleagues in the Trade and Competitiveness Global Practice on non-financial constraints is also extremely important.

Bringing the diverse expertise and perspectives of staff working across the institution through its “SME Finance Quick Lessons” series, the Finance and Markets Global Practice – and the SME Finance Community of Practice – is eager to share lessons drawn from the experience that inform our work, to educate practitioners and to highlight the achievements of our clients.

In this compendium of SME Finance Quick Lessons, *What’s Happening in the Missing Middle? Lessons from Financing SMEs*, we bring together several approaches to the SME story, exploring policies and frameworks to support SMEs, analyzing innovations in the SME finance realm, and describing some country specific examples. These lessons will provide SME practitioners with practical guidance for their work with the SME sector, and they will also inform and educate policymakers about interventions and approaches that they can consider.

By harnessing the knowledge and experience from across the World Bank Group to tackle the wide range of challenges and opportunities in serving the SME sector, we hope to contribute to and inspire informed dialogue about what works (and what doesn’t) in this critical sector of the economy.

Ceyla Pazarbasioglu-Dutz  
Senior Director,  
Finance and Markets Global Practice



# ACKNOWLEDGMENTS



*What's Happening in the Missing Middle? Lessons from Financing SMEs* is a collaborative effort of the SME Finance Community of Practice (CoP) under the leadership of Simon Bell, Global Lead for SME Finance in the Finance and Markets Global Practice of the World Bank Group. The CoP acts as a platform to connect people and ideas – drawing on the best across the World Bank Group, and is comprised of dedicated staff who contribute their time, expertise and knowledge to advance the agenda on SME Finance.

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# PREFACE



There is a growing realization of the importance of small and medium scale enterprises (SMEs) in virtually every economy in the world. While some SMEs can play a critical role in creating jobs – they also perform other exceedingly important functions such as supporting innovation, helping with diversification and beyond. However, these enterprises are generally perceived as risky by most banks – and access to finance is an important constraint on them playing a fuller role in supporting economic growth, jobs and development.

In the aftermath of the global recession many countries are grappling with the challenges posed by SME financing. Policymakers need to ensure that there is a sufficient supply of appropriate financing across all stages of SME growth - from business ideation and incubation, to angel, seed and growth acceleration and finally through to traditional banking and/or IPO financing options. In particular, identifying and supporting the fastest growing SMEs, or gazelles as they are called, within the much larger pool of small and medium enterprises – promises to provide the growth and job creation that so many countries are now finding particularly elusive.

In a rapidly changing world, innovative and creative solutions must be sought and piloted. Already the financial world is evolving in dramatic and possibly unpredictable ways. The rise of crowd funding and other forms of digital finance and finTech solutions are opening up new opportunities and

risks that policymakers have not had to deal with in the past. International institutions, such as the World Bank Group, are looking to adapt to this fast changing world – as are the European Union, the World Economic Forum (WEF), the Organisation of Economic Co-operation and Development (OECD), the G-20 and others.

Sharing our experiences, analysis and even our failures, is an important way for us all to learn. This compendium, *What's Happening in the Missing Middle? Lessons from Financing SMEs*, is an initial effort to do just that. Whereas these SME Finance Quick Lessons were initially developed for an internal World Bank Group audience (and, in particular, the members of the SME Finance Community of Practice), the intent with this compendium is to open that dialogue to an external audience. It is hoped that your reactions to these lessons, information about your own experiences and a wider dialogue on the issues that we all face around these topics will enrich all of our work and ensure more sustainable solutions for SME development across the globe.

Simon C. Bell

Global Lead, SME Finance  
Finance and Markets Global Practice  
The World Bank Group



# POLICIES AND FRAMEWORKS FOR SME FINANCE



Following the financial crisis of 2007-2008, international institutions have redoubled their commitment to building more resilient economies around the globe. At the center of this commitment is a drive to increase access to finance for small and medium scale enterprises (SMEs). The European Union is placing increased emphasis on SMEs and their growth potential, and the World Economic Forum (WEF) and the Organisation for Economic Co-operation and Development (OECD) are also producing policy papers, analysis, and recommendations on SME finance. Equally important, the G-20 countries are placing SME support – and particularly SME finance – at the top of their agenda. Beginning in 2015 with the Turkish presidency of the G-20 and continuing into 2016 and 2017 with the Chinese and German presidencies, SME finance has been accorded one of the highest priorities, resulting in the development of guidelines as to how governments can be more supportive in meeting the financing needs of their SME sectors.

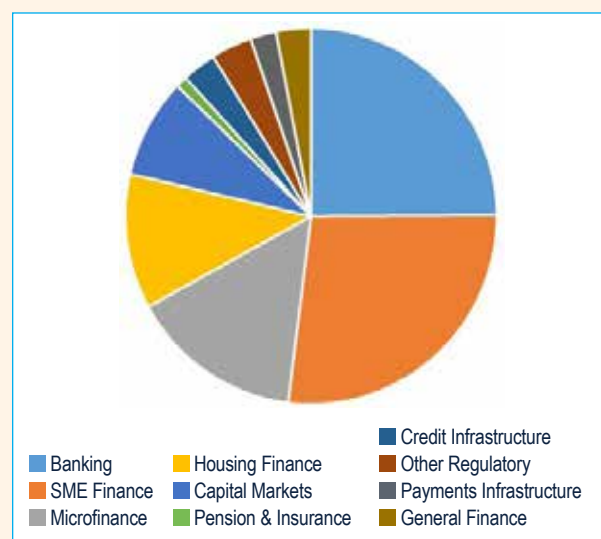
A central emphasis of work on SMEs has been on establishing a supportive financial infrastructure for SME lending – particularly around credit information systems, the establishment of secured transactions legislation and registries, adoption of modern insolvency and creditor rights regimes, the development of increasingly efficient and digitalized payments systems, and stronger accounting and auditing practices within the SME sector.

It is within this context that the World Bank Group’s Finance and Markets Global Practice (F&M GP) propagates various policies as tools to support increased access to finance for SMEs. The main vehicle that the World Bank Group (World Bank) has historically used to support the financing of SMEs is through lines of credit – generally

channeled through an apex on-lending institution to commercial banks and then on to SMEs. This line of credit instrument has been used extensively across the World Bank. For instance, in the energy sector, the World Bank is increasingly using lines of credit to support smaller scale renewable energy and energy efficiency projects; in the urban sector, the World Bank has used lines of credit for housing finance purposes; and in agriculture, the World Bank has used lines of credit to finance small and medium scale farmers.

Within the F&M GP, SME lines of credit have been used in many different ways: as general lines of credit to support all SMEs on a sector agnostic basis; as support for female entrepreneurs; as support for small and medium sale exporters; and as support to a specific sector. As illustrated in the graph below, the second largest lending activity of the Finance and Markets GP over the period 2013 to 2015 was in support of SMEs.

**Thematic Distribution of Total Commitments, FY13 - FY15**



Having responsibility for financial system development and deepening, the F&M GP has been tasked with ensuring that World Bank Group lines of credit do not cause distortions within the financial sectors in which the World Bank lends. An Operational Policy (OP10) has specifically been developed to establish guidelines for project staff who are operating in this field. The Finance and Markets Global Practice is tasked with reviewing all of these operations and providing advice in terms of compliance with the overall World Bank guidelines on financial intermediary lending. A chief concern is that funds – which are initially lent to the sovereign, then through an apex institution, to financial institutions and ultimately to SMEs – do not distort the market by setting interest rates lower than existing market rates without very compelling reasons for doing so. Although generally less well known and less well used, these operational guidelines also cover credit guarantee operations and equity support operations – which are likely to become increasingly more important in the future. Within this environment, there has also been a growing interest in the power of credit guarantee schemes (CGSs) to support more bank lending to SMEs. Many countries have functioning CGSs which have demonstrated their ability to increase overall levels of lending to the SME sector and reduce collateral requirements on such lending while also reducing the interest rates charged. On the other hand, poorly designed CGSs have yielded poor results and, in some regions, have resulted in a poor reputation for such schemes. The ‘magic’ is in the design of these schemes and is the major determining factor in how successfully they operate.

The following SME Finance Quick Lessons provide some of the foundational policies and frameworks which we use in the World Bank when dealing with SME Finance:

- The first SME Finance Quick Lesson (QL) provides a review of the Finance and Markets Global Practice Action Plan for dealing with SME Finance issues for the next five years.
- It identifies a set of 24 priority countries for support – which have been prioritized on the basis of their SME financing gap (both in absolute and in relative terms). The Action Plan also identifies priority areas of action for the F&M GP as well as targets that it intends to achieve over the next five years.
- While credit guarantee schemes exist in many countries, their success in supporting increased SME lending at lower cost and with lower collateral requirements varies considerably. In conjunction with regional credit guarantee agencies from around the globe, the World Bank Group has worked to establish a set of good principles for public credit guarantee agencies. These are described in full in the second Quick Lesson in this section.
  - The OP10 SME Finance Quick Lesson describes the operational policies which World Bank line of credit lending operations are meant to follow. While seeking to ensure full compliance with these procedures, this Quick Lesson simultaneously tries to ensure that legitimate and important development objectives can be met while still ensuring compliance. The objective being to ensure that this guidance plays a supporting rather than a policing role.
  - In the final Quick Lesson in this section, high level policy guidelines describe the priorities of the G-20 in their efforts to ensure global support for SMEs. These cover three main areas, including: (a) legislation, regulation and supervision; (b) financial market infrastructure; and (c) public intervention and support mechanisms. In the final Quick Lesson in this section, high level policy guidelines describe the priorities of the G-20 in their efforts to ensure global support for SMEs. These cover three main areas, including: (a) legislation, regulation and supervision; (b) financial market infrastructure; and (c) public intervention and support mechanisms.

# The World Bank Group's Small and Medium Enterprise Action Plan

- Simon Bell and Ghada O. Teima<sup>1</sup> -



## INTRODUCTION

There is an increasing recognition of the importance of Small and Medium Scale Enterprises in terms of supporting overall economic growth and development. As a consequence, the Turkish Presidency of the G-20 (in 2015) placed considerable emphasis on the importance of SME development and worked to highlight SME related issues further in the Global Economy. Other governments and key international institutions have also increasingly focused on the issue of SME support (particularly financial support).

A key driver of the increased interest in SMEs is their contribution to employment. Indeed, most formal jobs in emerging markets are SME jobs – seven out of ten formal jobs are created by SMEs – and this rises to nine in ten jobs in some low income countries. Given the fact that the global economy needs to generate 600 million new jobs over the next 15 years – just to absorb the growing workforce and begin to tackle some of the current unemployment issues – this makes SME development a high priority for many governments around the world, both in developing as well as in developed economies.

However, SMEs are not only valued for their potential to generate jobs. The establishment of a competitive SME sector can also create a more diversified, agile, and resilient economy with enhanced productivity and competitiveness. A vibrant SME sector can enhance innovation, it can help to diversify economic activity geographically,

it can support women and young entrepreneurs, and it can also help to support other development goals such as food security, better health and education, and a reduction in climate change.

## ACCESS TO FINANCE FOR SMEs

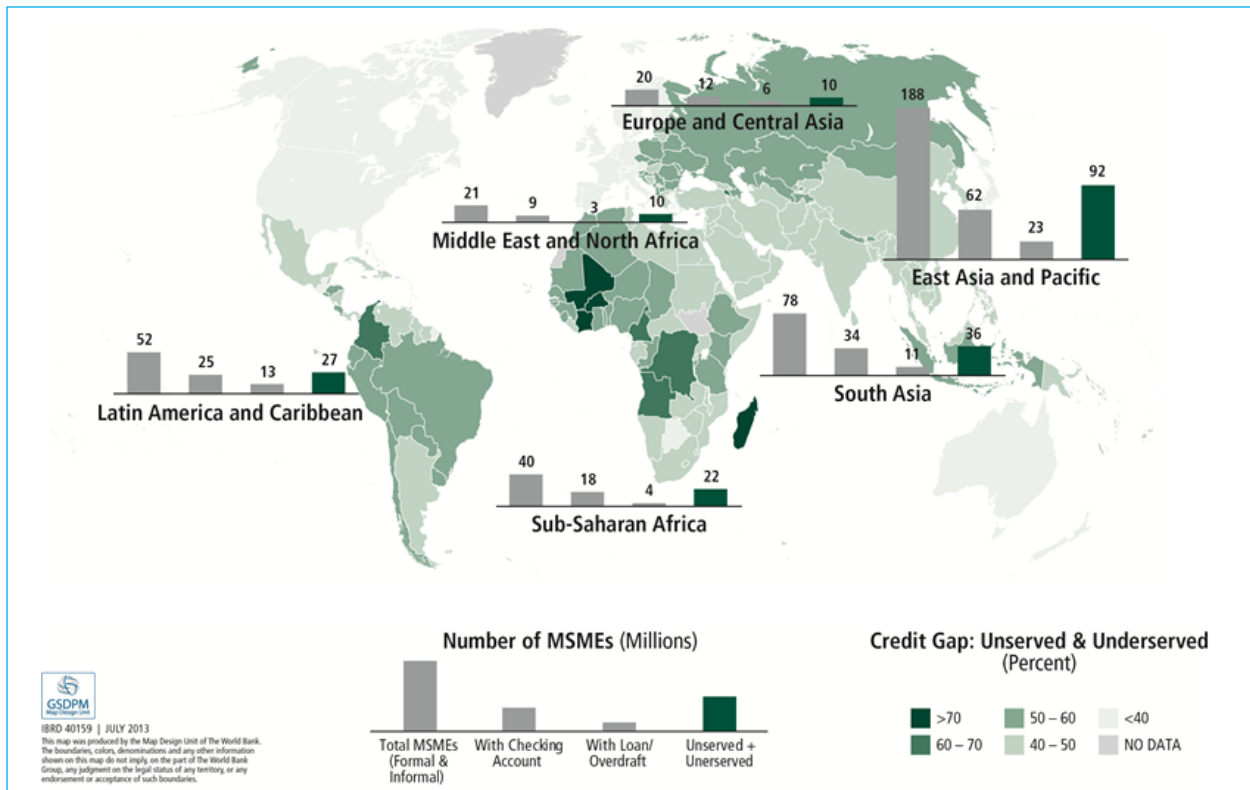
One of the biggest constraints to SME development is a lack of financial resources to start, sustain and grow their businesses. It is calculated that between 55 to 68 percent of formal SMEs in emerging markets are either unserved or underserved by financial institutions. The total credit gap of formal SME enterprises stands at between \$0.9 to \$1.1 trillion – while the total credit gap for formal and informal enterprises is estimated at between \$2.1 to \$2.6 trillion (see map below). According to Investment Climate Surveys, in over 70 percent of countries, SMEs cite access to finance as the single biggest obstacle to them doing business (followed by access to electricity, informality, tax rates, and political instability)

## THE TWIN GOALS

SME Finance is also directly linked to the Twin Goals of the World Bank – reducing poverty and increasing shared prosperity. With their contribution to employment generation, SMEs are assisting with job creation as well as with national income growth. Jobs are also a principal way out of poverty. With increased incomes deriving from increased employment, households are able to consume more basic goods and services, and thereby reduce poverty rates.

<sup>1</sup> Simon Bell is Global Lead for SME Finance and Ghada O. Teima is Lead Financial Sector Specialist in the Finance and Markets Global Practice of the World Bank Group.

## Total Credit Gap for Formal and Informal Enterprises is \$2.1 to \$2.6 Trillion



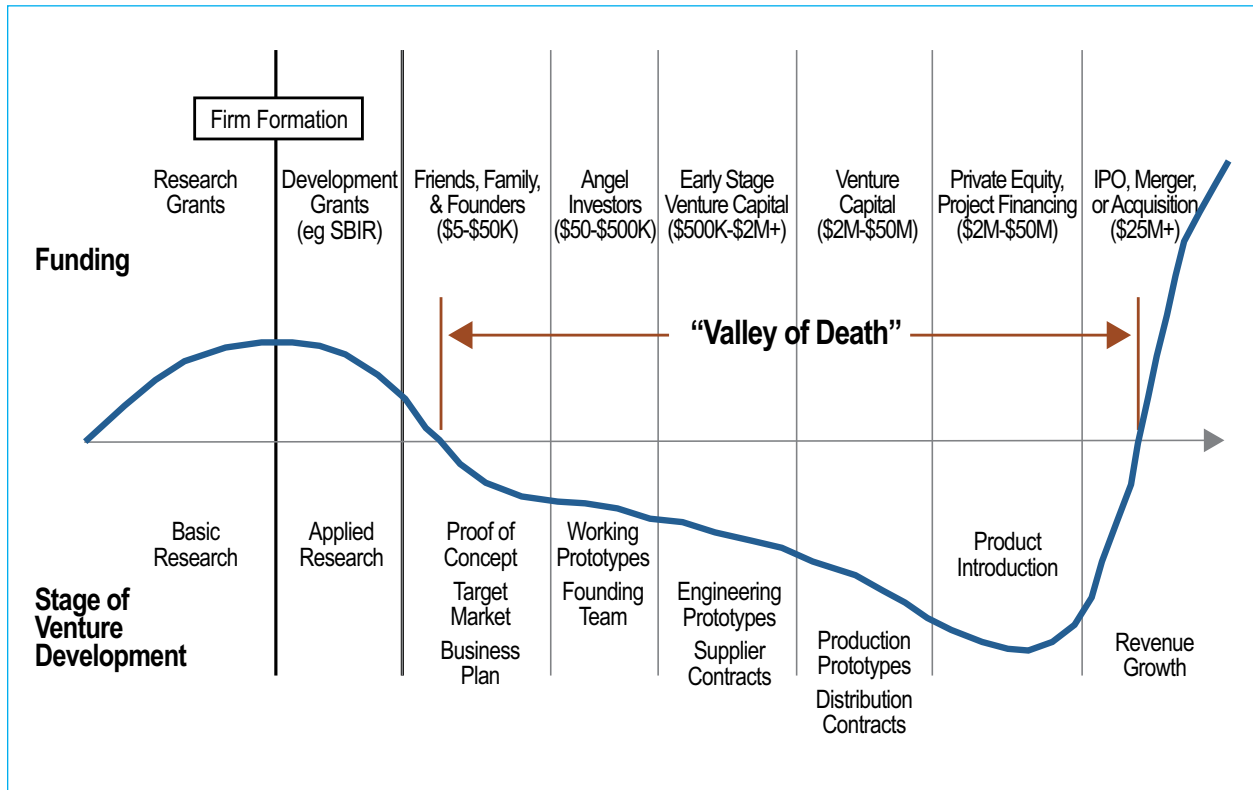
### SMEs NEED A MIXTURE OF DEBT AND EQUITY TO GROW

Firms need different types of financing, which are likely to change and evolve as they grow. For instance, most SMEs commence operations with their “own funds” – generally called money from “friends, family, or fools”. However, the financial needs of most growing firms quickly expand beyond the limited capabilities of this group – and unless alternative forms of financing can be secured, then firms will either stagnate or, worse still, die. Locked out of bank financing, SMEs are highly likely to enter into what is called the “Valley of Death” and die, unless equity support, trade finance, or even small amounts of bank (or other financial institution) finance is made available. The graphs below illustrate the typical life cycle of an SME firm – as well as the share of funding types used globally by SMEs – taken from the Enterprise Survey data (for both investment and for working capital). The reliance of “own funds” (or internal funds) is significantly higher in developing countries – a factor which, in the absence of alternative funding modalities, stunts their growth and overall economic development.

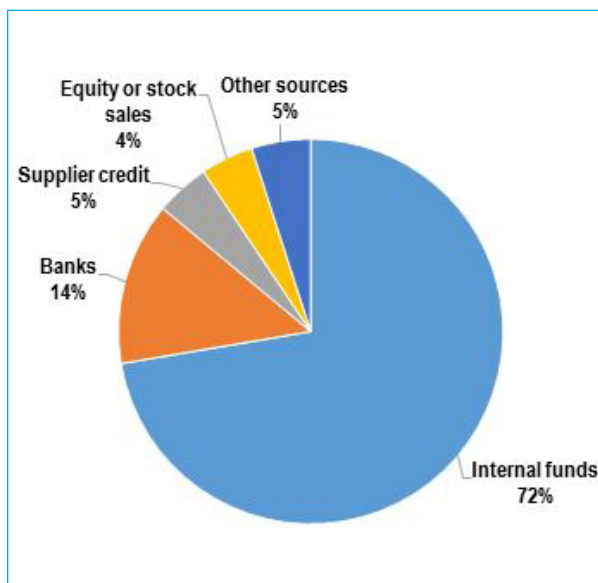
### THE SME ACTION PLAN

Based upon the importance of SMEs and the considerable constraints faced by these enterprises in accessing financing, the Finance and Markets Global Practice has developed an SME Action Plan. This effort began with a prioritization exercise which examined the countries with the largest SME Financing Gaps – in terms of the formal sector financing gap (mainly); the combined formal and informal gap; and also those countries that had the largest relative financing gap. This latter dimension was important because the largest absolute gaps are, understandably, found in the larger countries such as China, India, Brazil – while some of the biggest relative gaps (i.e. the countries where the highest share of SMEs are denied access to bank financing) were in smaller African countries such as Burkina Faso, the Democratic Republic of the Congo, Tanzania and Mozambique. Based upon this data – and an evaluation of where World Bank Group interventions could be most effective, a group of 24 priority countries were selected for initial focus (with shares of the total formal gap indicated below).

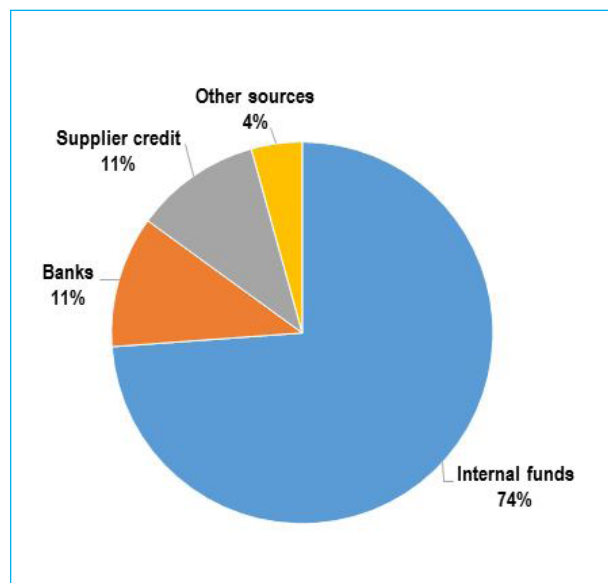
## Lifecycle of a Venture

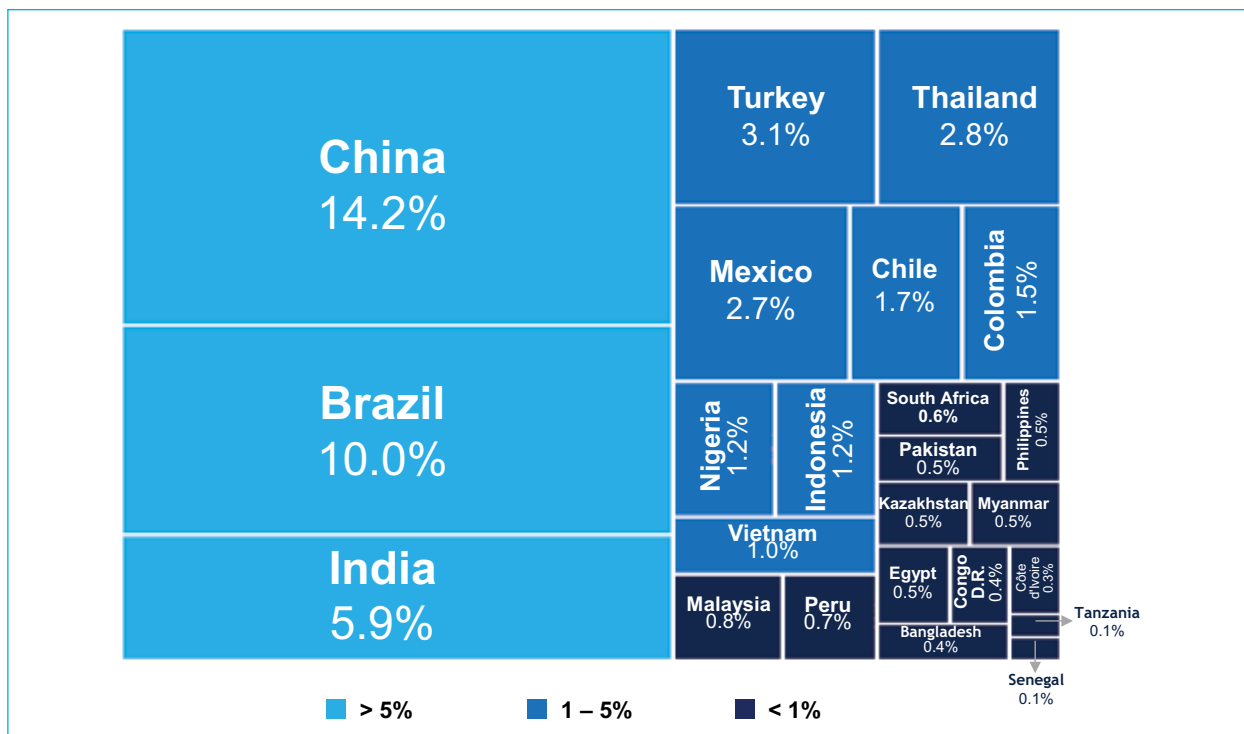


## Financing of Investments All Countries



## Financing of Working Capital All Countries





It will, nevertheless, be important to interpret this priority list flexibly – while recognizing that progress may be made in other countries which may well substitute for slow progress in some of the countries in this group.

What is the World Bank Group doing to support the financial needs of SMEs? The main work programs within the Finance and Markets Global Practice involve support for the following types of activities:

- Financial Sector Infrastructure – credit information; secured transaction registries; insolvency regimes;
- Streamlining Payments systems;
- SME Lines of Credit;
- Partial Credit Guarantee schemes;
- Alternatives to Banks – particularly non-bank financial institutions such as leasing and factoring companies;
- Working with State Owned Institutions which service SMEs (urban and rural) such as state owned agricultural banks;
- Early Stage Innovation Finance;
- Franchising Finance;

- Some Islamic Financing for SMEs; and
- Policy work, Analytical work, and Other Advisory Services.

In addition, the rapid emergence of digital finance, particularly in Africa, and the growth of finTech companies in the wake of the Global Financial Crisis (post 2009), has witnessed the emergence of many new and innovative approaches to SME financing. While the F&M Global Practice will continue to emphasize the work that we are already doing in the SME space over the recent past, the F&M GP will also seek to “push the envelope” in terms of developing new and innovative approaches to dealing with the particular challenges of SME financing. For example:

The following areas will be initial areas of focus:

- Digital finance (electronic payments – particularly G2B and B2B payments and other innovations such as replication of the NAFIN Model in Mexico and Crowd Funding models);
- Early Stage Innovation Financing (angel, seed, venture, etc); and
- Securitization of SME loans.



And potential other areas could include:

- Value Chain Financing – particularly warehouse receipts for farmers;
- Scaling-up Franchising Models;
- Social Impact Bonds/Development Impact Bonds;
- Impact/Social Investing and SME support; and
- Regulatory Interventions in support of SMEs (and the role of Central Banks).

## PARTNERSHIPS

Of course, the constraints faced by SMEs in our client countries are not only financial. There are many other non financial issues which adversely impact the efficient functioning of SMEs. Indeed, SME issues are of concern to a wide group of players across the World Bank Group. These include the Financial Institutions Group (FIG) of the International Finance Corporation, the SME Finance Forum, the Trade and Competitiveness Global Practice, infoDEV, and the World Bank and IFC and Treasuries, among others. Partnering with these disparate parts of the World Bank Group will be critical in leveraging the full expertise of the institution to the benefit of SMEs in emerging economies.

Partnerships with external partners will also be important including the G-20, the B-20, the OECD, APEC and ABEC, the World Economic Forum, etc – all of whom have a considerable interest in supporting SMEs in both the developed as well as the developing world.

## TARGET OBJECTIVES BY 2020

To focus the work of the SME team, the Action Plan lays out a series of action items with target dates (most importantly 2020). These include:

- **“Closing the Gap”:** At minimum, bridge \$200 billion of the SME financing gap, in a responsible manner, by 2020 (between F&M and FIG) Align with FIG targets + Agree with Regions on SME regional targets;
- **Job Creation:** Support the creation of 100 million net new jobs – which involves sustaining existing jobs and identifying and supporting “gazelle” (very fast growing firms);



- **Women, Youth, Post Conflict Targets:** Establish firm targets for gender headed firms and youth headed firms – as well as targets for Post-Conflict environments. And align these with the respective Cross Cutting Solutions Areas (CCSAs);
- **Lending Targets:** Double the number of loans to IDA countries – with a specific focus on Africa;
- **Advisory Targets:** Establish Advisory Services targets for financial infrastructure (credit bureaus, secured transactions registries, and insolvency and credit rights frameworks), to enhance our holistic value proposition.
- **Pilot Innovative Approaches to SME Finance:** The F&M GP will adopt, pilot and assess three to five new innovative approaches to SME financing;
- **Fund Raising:** Raise \$80 million in donor funding in support of SME financing;
- **Reimbursable Advisory Services:** Develop \$20 million of RAS work, over the next five years, for the F&M GP – within the SME space; and
- **Country Diagnostics:** undertake to complete three new country Action Plans per year from the list of priority countries.



# Principles for Public Credit Guarantee Schemes for Small and Medium Enterprises

- Pietro Calice<sup>2</sup> -



## INTRODUCTION

Financial inclusion, particularly for small and medium enterprises (SMEs), is widely recognized as one of the key drivers of economic growth and job creation in all economies. SME credit markets are notoriously characterized by market failures and imperfections including information asymmetries, inadequacy or lack of recognized collateral, high transaction costs of small-scale lending and perception of high risk. In order to address these market failures and imperfections, many governments intervene in SME credit markets in various forms.

A common form of intervention is represented by credit guarantee schemes (CGSs). A CGS provides third-party credit risk mitigation to lenders with the objective of increasing access to credit for SMEs. This is through the absorption of a portion of the lender's losses on the loans made to SMEs in case of default, typically in return for a fee. The popularity of CGSs is partly due to the fact that they commonly combine a subsidy element with market-based arrangements for credit allocation, therefore involving less room for distortions in credit markets than more direct forms of intervention such as state-owned banks or interest rate subsidies.

CGSs can potentially play a more important role, especially in countries with weak institutional environments, by improving the information available on SME borrowers in coordination with credit registries, and by building the credit origination and risk management capacity of lenders (e.g. through technical assistance for the establishment of SME units). Moreover, CGSs can

be leveraged to provide countercyclical financing to SMEs during a downward economic cycle, when risk aversion may increase and a credit crunch is likely to develop.

More than half of all countries in the world have a CGS in place and the number is growing. As a result of the global financial crisis as well as of the international community's increasing emphasis on SMEs as an engine for growth and employment, there has been renewed interest from governments in CGSs. A CGS can be a critical policy instrument for easing financing constraints for SMEs thus contributing to sustainable economic development and job creation.

For that purpose, it is important to ensure that CGSs are properly designed and operated to achieve both outreach and additionality in a financially sustainable way. Outreach refers to the scale of the CGS, as measured by the number of guarantees issued to eligible SMEs and the amount of outstanding guarantees. In principle, the greater the outreach, the stronger is the impact of the CGS on the SME sector. However, the impact of the CGS on the supply of credit to the SME sector will also depend on whether guarantees are solely or mainly extended to SMEs that are credit constrained either in terms of access or in terms of unfavorable conditions such as cost and maturity (financial additionality). It is also important that there is ultimately an improvement in the overall economy as a result of increased access and availability of capital for SMEs (economic additionality). Finally, reaching SMEs that are credit constrained involves risk-taking and financial losses. Public CGSs are not designed or expected to make a profit. However,

<sup>2</sup> Pietro Calice is Senior Financial Sector Specialist in the Finance and Markets Global Practice of the World Bank Group.



they should still be financially sustainable in the long-term, i.e. able to contain losses and ensure an adequate equity base vis-à-vis their expected liabilities, through sufficient funding, effective risk management and sound operational rules.

Against this background, the World Bank Group and the FIRST Initiative convened and provided secretariat support to a Task Force representing international associations of both CGSs and lenders to develop a set of [Principles](#) for the design, implementation, and evaluation of public CGSs for SMEs.

## OBJECTIVES OF THE PRINCIPLES

The objective of the Principles is to provide a generally accepted set of good practices, which can represent a global reference for the design, execution and evaluation of public CGSs. The Principles propose appropriate governance and risk management arrangements as well as operational conduct rules for CGSs, which can lead to improved outreach and additionality cum financial sustainability. The Principles build upon extant literature on good practices for CGSs, including global and regional surveys, and draw from existing CGSs' sound practices as implemented in a number of jurisdictions. Distilling these practices into internationally accepted Principles is expected to improve CGSs' performance while at the same time advancing knowledge and awareness of CGSs and of their role in the economy. The Principles are also expected to guide CGSs,

including newly established ones, to develop, review or strengthen their organization, operations and risk management practices.

To ensure a sound application of the Principles, a constructive and collaborative response from the recipient countries, including the financial sector, is essential. The Task Force is of the view that the Principles, if properly implemented, will help financial sector development and ultimately improve access to credit for SMEs.

## SCOPE OF APPLICATION

The Principles are developed for the purpose of being applied to public CGSs for SMEs. Public CGSs for SMEs are institutions created by the government, which retains de jure or de facto control as defined in relevant home country laws, to provide credit guarantees to lenders to ease access to credit for SMEs operating in their jurisdictions. Target SMEs may operate in any sector, including agriculture. Public CGSs can be national, regional or local in scope. The Principles are also intended to be applied to two-tier CGSs, where there is a system of CGSs operating locally which reinsure part of their risk to a central counter-CGS. The Principles, however, include a number of good practices, which can be applied to other forms of CGSs as well, including international, cross-border CGSs, donor-funded CGSs and privately-owned CGSs.

## NATURE

The Principles are a set of good practices that public CGSs are implementing or expect to implement on a voluntary basis. Given their intended general nature, the Principles are envisioned to be applicable in all jurisdictions, regardless of their relative level of economic and financial sector development.

The Principles are expected to guide country authorities in the design, implementation and evaluation of existing and new CGSs, and to help inform any related policy, legal and institutional reforms. At any rate, the Principles are subject and subsidiary to existing home country laws and regulations. They complement rather than substitute other relevant international standards and codes as applicable to CGSs.

## PRECONDITIONS FOR EFFECTIVE DESIGN, IMPLEMENTATION AND EVALUATION OF CGSs

CGSs are established to address market failures, which prevent SMEs from accessing credit in the quantity and quality that is socially and economically desirable. Hence, they are not an end in themselves but rather a means to solve a problem. It is, therefore, essential that the market failures be comprehensively analyzed to identify and define the problems to be addressed, and determine whether there is evidence that government intervention through a CGS is justified. Governments are nonetheless encouraged to pursue all the necessary legal, regulatory and institutional reforms to ameliorate the enabling environment for access to credit for SMEs.

Even if the analysis of market failures suggests that intervention through a CGS are justified in principle, an effective CGS requires a number of external elements or preconditions, which may have a direct impact on the achievement of its policy objectives. These preconditions comprise: (i) a system of

business laws, including corporate, bankruptcy, contract, collateral, consumer protection and private property laws, which provide an acceptable degree of enforcement and a mechanism for a fair resolution of disputes; (ii) a sufficiently efficient and independent judiciary; (iii) a comprehensive and well-defined set of accounting standards and rules, and reasonably well regulated legal, accounting and auditing professions; and (iv) a sound and liquid financial system able to originate and manage credit effectively.

These preconditions are normally outside the control or influence of CGSs. Where CGSs have concerns that the preconditions could impact their effectiveness, they should make the government and relevant stakeholders aware of them and their actual or potential negative repercussions for the achievement of the intended policy objectives. CGSs should also, as part of their normal business operations, adopt measures to address the effects of such concerns on the effectiveness of their activities.



## OUTLINE

The Task Force has identified four key areas for the success of public CGSs. Accordingly, the Principles cover the following key dimensions:

- Legal and regulatory framework;
- Corporate governance and risk management;
- Operational framework; and
- Monitoring and evaluation.

Good practices in the first area are intended to provide the foundations for a CGS, i.e. its legal basis and the regulatory and supervisory framework. A sound corporate governance framework and risk management infrastructure, set out in the second area, is a critical building block for an effectively designed and independently executed strategy aligned with the CGS's stated mandate and policy objectives, while ensuring proper monitoring of both financial and non-financial risks. A clear operational framework, the subject of the third area covered by the Principles, provides CGSs with a course of action vis-à-vis essential working parameters. Finally, good practices identified in the fourth area show how CGSs are expected to report on their performance and, more importantly, evaluate the achievement of their policy objectives.

## IMPLEMENTATION AND REVIEW

The Task Force acknowledges that implementation of the Principles may be challenging in some countries, requiring an appropriate transitional period, especially for newly established CGSs. Accordingly, the Principles are formulated broadly enough to accommodate different legal, regulatory and institutional settings in various jurisdictions.

The Task Force also acknowledges that several aspects of the Principles could benefit from further study and work. The evolving nature of the financial system, of which CGSs are an important component in many jurisdictions, as well as further experiences of public CGSs are likely to produce the need for re-examination of some aspects of the Principles over time. Continuing coordination and consultation at the international level is also desirable for other issues of common interest to CGSs.

To facilitate this, the Task Force has agreed to consider its evolution into a permanent Standing Group of CGSs, with terms of reference to be developed and decided among its members. This Standing Group would be able to periodically review the Principles, as appropriate, as well as provide member organizations with a continuing forum for exchanging ideas and views. The Standing Group could also examine ways through which aggregated information on CGSs around the world could be periodically collected and made publicly available.

# Standards for SME Credit Lines: Raising the Bar without Raising the Barriers

- Mike Goldberg<sup>3</sup> -



## INTRODUCTION

Every country and counterpart wants to be considered a special case, but the World Bank Group maintains some good practice policies to avoid repeating past mistakes. At the same time, there are national conditions that warrant flexibility – and nowhere is this clearer than in lines of credit (LOC). This note is intended to set out the central good practices and issues for lines of credit, as well as what can go wrong. For each issue or requirement, specific suggestions are provided, which may not fit every situation.

## ARE LINES OF CREDIT THE RIGHT APPROACH?

Sometimes grants make more sense, sometimes a credit risk guarantee mechanism. If there is excess liquidity in the system, a line of credit might not work – at least not without an understanding of the market failures that are barriers to broader, deeper access.

**Suggestion:** Lines of credit might work when longer maturity loans are missing, specific sectors have no access to credit, there is a need for temporary liquidity (emergencies, civil disorder, economic crisis) and/or low income individuals and households are excluded systematically. If a LOC is needed, where do you begin?

## THE STARTING POINT: MACROECONOMIC FRAMEWORK AND SITUATION

Lines of credit are most effective when the macroeconomic environment is stable, predictable

and not marked by spikes in inflation, sudden shifts in policies or widespread market imperfections. These issues affect the willingness of financial institutions to take on long term risks, and the willingness of borrowers and savers to make long term decisions on investments and business expansion. Lines of credit can also help respond to an economic crisis, if it is not driven by unpredictable policies.

**Suggestion:** Check with the country's central bank and Ministry of Finance, the Bank's country economist and the IMF on trends, risks, policies and plans. Match the objectives and types of loans envisioned to the macroeconomic stability projections. Consider indexing interest rates on loan contracts when dealing with an emergency, to protect the financial institutions in extreme cases.

## STEP TWO: FINANCIAL INFRASTRUCTURE

Financial sector market imperfections are typically based on a lack of information on a client's proposed investment project, historical performance and character (as it affects timely repayment of a loan). Well-designed lines of credit may still be ineffective if key pieces of financial infrastructure are missing.

**Suggestion:** Assess the constellation of laws, regulations and systems in place, from a collateral registry to credit information systems, financial literacy and consumer protection.

## NEXT STOP, THE FINANCIAL SECTOR

If this sector is dominated by state banks or heavy handed government intervention (for example large scale policy lending), the line of credit may be

<sup>3</sup> Mike Goldberg is Lead Operations Officer in the Finance and Markets Global Practice.

exposed to non-commercial pressures. These can include interest rate subsidies, interest rate caps, unfair competitive advantages to retail state banks, election campaign pressures for client selection and regional targeting.

**Suggestion.** *Financial institutions are (usually) rational actors – understand their perspective, needs and what incentives they need to reach out to new markets (such as SMEs) and test new products (like leasing or warehouse financing). In the project document, explain how the proposed operation fits into the existing context without creating distortions.*

## THE ROLE OF THE GOVERNMENT

Governments often seek to use the financial sector for policy objectives – like poverty alleviation, regional development, jobs creation, and growth in strategic sectors. Problems begin when (i) the government works in a segment at both the wholesale and retail level, (ii) it artificially controls the interest rate, or (iii) it uses political criteria to allocate scarce loan funds. Government agencies responsible for financial sector soundness and protecting the public (for instance, savings deposit protection) may be weak.

**Suggestion:** *Asking for a strategic plan for each public sector bank and supervisory agency (for banks and non-bank financial institutions) helps to understand their vision and the role they intend to play. Then the project design team can decide if these roles need support (technical assistance, investments) and what might be required to ensure a sound, sustainable competitive financial sector.*

## DEEP DRILLING ON POTENTIAL RETAIL FINANCIAL INTERMEDIARIES

There is a huge range of portfolio performance among retail financial institutions in a country, which can be caused by such diverse factors as policies, client selection techniques, loan collection enforcement methods, investor pressure and the governance structure. How can lines of credit be set up to attract the sound retailers?

**Suggestion:** *Analyze how the proposed participating financial institutions (PFIs) are expected to comply with each of the following requirements on governance and systems. Audits, operational manuals, discussions with supervisors and financial*

*statements can all help this assessment. This can lead to a pre-screened list of possible partner banks and other financial intermediaries. Below is the normal list of indicators covering systems, governance and financial soundness indicators (capital adequacy, non-performing loans, loan loss provision, liquidity ratio, etc.):*

- *Profitability, capital and portfolio quality, as confirmed by financial statements prepared and audited in accordance with national and standard international accounting and auditing principles,*
- *Levels of loan collections;*
- *Lending technology, reporting systems/MIS, staffing for carrying out sub-project appraisal (including environmental assessment) and for supervising subproject implementation;*
- *Capacity to mobilize domestic resources (savings, bonds, government budget support, other sources);*
- *Adequate managerial autonomy and commercially oriented governance (particularly relevant when state-owned or state-controlled FIs are involved); and*
- *Appropriate prudential policies, administrative structure and business procedures.*

## FOLLOWING THE FLOW OF FUNDS: PROJECT LEVEL

There are two models that the World Bank supported projects use, with the difference being a single retail provider or a wholesale financial institution working with several eligible retailers (see figures on page 16). To appraise the line of credit, the project design team needs to know the flow of funds including the cost to each actor and the price (and fees) they charge, subsidies throughout the system, the credit risk holder and the currency risk holder.

**Suggestion:** *A graphical flowchart can generate a discussion with counterparts in the design stage, to avoid surprises later – on costs, pricing and risk management. Since markets change, this should not be in a legally binding project agreement, only in the design documents and operational manual, where it can be adjusted by mutual consent without legal agreement (refer to figures on page 16).*



## TWO SIDES OF THE COIN: DIRECTED CREDIT

Directed Credit. Under some circumstances, directed credit can be used for policy reasons to prop up an unsustainable, uncompetitive sector. In other cases, it may be the only way to demonstrate commercial potential or a least cost poverty alleviation model.

**Suggestion:** State if the proposed operation envisages targeting specific sector(s)/types of beneficiaries and explain the rationale when directed credit is involved. Check the results from recent projects with directed credit activities.

## KEEPING SCORE: MONITORING

Disbursement of the credit line is great, but does not guarantee developmental impacts and the promised project developmental outcomes.

**Suggestion:** Use performance indicators that address the market failure at the overall project level, and go beyond disbursement amounts at the intermediate outcome level. A financial sector monitoring and evaluation expert can help to generate solutions.

## THE IRON LAW OF SUBSIDIES – THE CHEAPER THE MONEY, THE LESS LIKELY IT WILL GO TO THE TARGET GROUP

Interest rate subsidies are the culprit. Cheap loans are rationed, and rationing opens the door to political considerations. Then there are the borrower's expectation of permanent subsidies, the fiscal costs and lack of sustainability.

**Suggestion:** Stick to the basics. Interest rates include a risk premium, which means untested client groups (such as SMEs) have to pay a little more. It can be useful to subsidize training, transaction costs, technology and new product development – just not the interest rate. Here is the list for smart and more effective subsidies, in keeping with World Bank financial sector policies and good practices. Subsidies should be:

- transparent, targeted, time-limited and capped;
- funded explicitly through the government budget or other sources subject to effective control and regular review;
- fiscally sustainable;



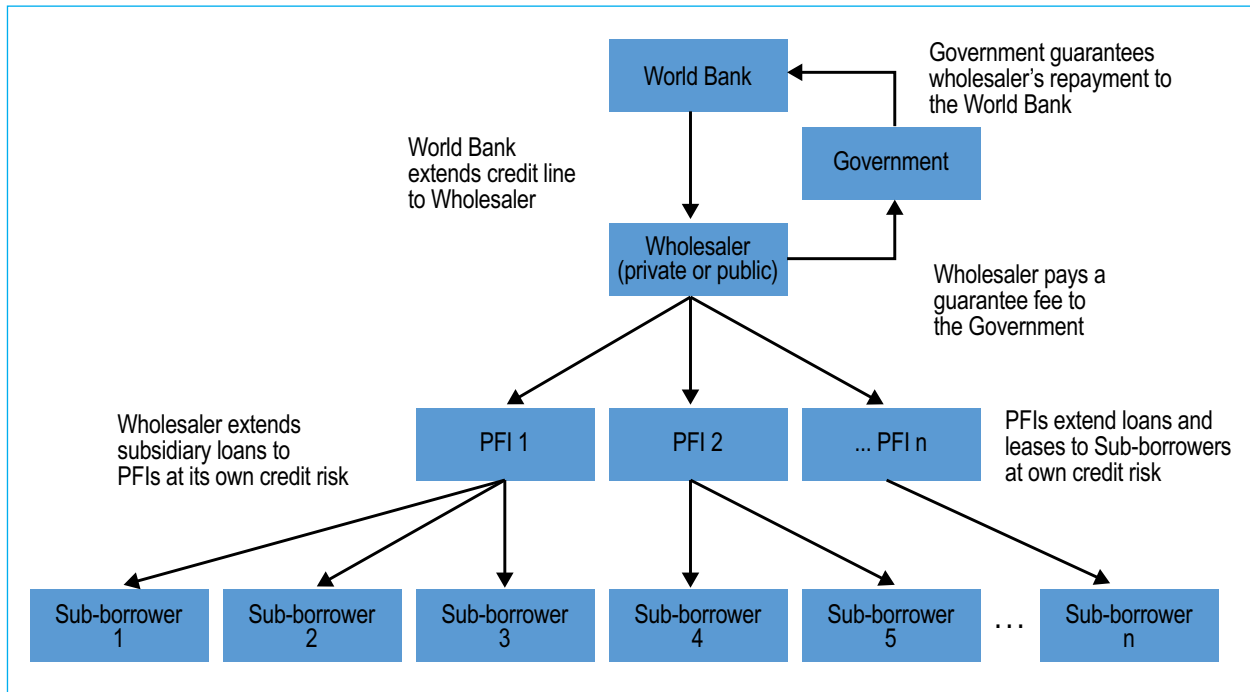
- set up to maintain a level playing field, so they should not give an unfair advantage to some PFIs as compared to other qualified and directly competing institutions; and
- economically justified, or shown to be the least-cost way of achieving poverty reduction objectives.

## LET'S END WITH A LIST OF HELPFUL "DO'S"

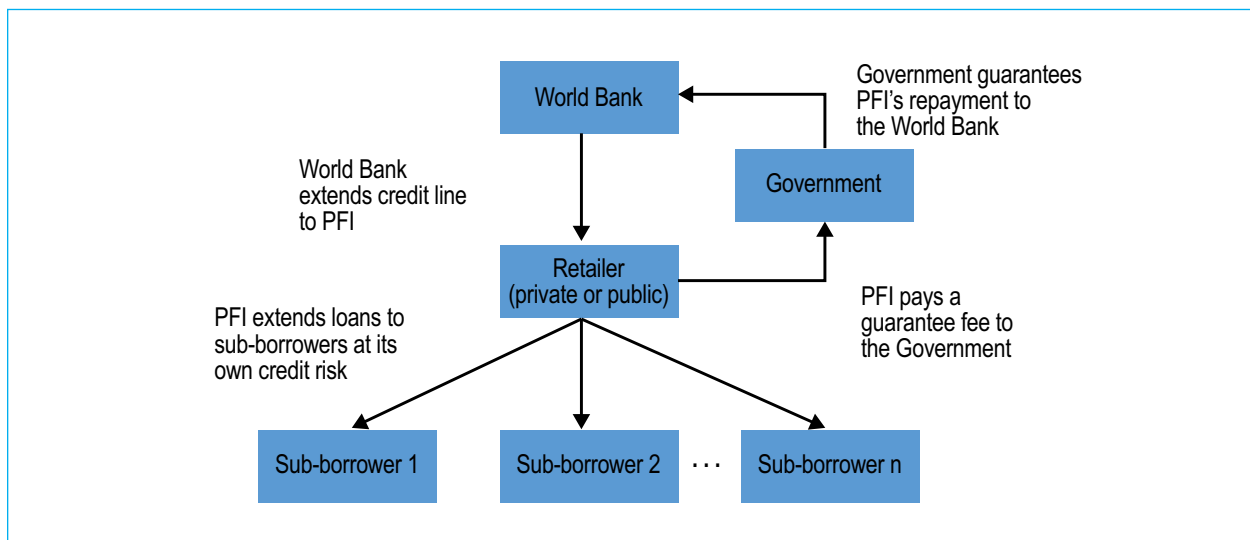
These are actions a project design team can do to avoid the lines of credit pitfalls:

- Do engage, early on, with financial sector technical experts for advice on design issues;
- Do check evaluations of World Bank financial sector projects for ideas and lessons;
- For World Bank staff, refer to the [OP 10 guidance note](#) (Financial Intermediary Financing, OPSPQ/FFIMS, 2015);
- Do start early, to manage counterparts' expectations that might not yield the desired outcomes;
- Do document lessons learned, to make a contribution to corporate level knowledge on credit lines.

## Flow of Funds Structure for Indirect Financial Intermediary Financing: Through Wholesaler and Participating Financial Institutions (PFI) as Intermediaries



## Flow of Funds for Direct Financial Intermediary Financing with only the Participating Financial Institution as Intermediary



Source: Investment Project Financing – Financial Intermediary Financing, World Bank, 2014 (OP10 Guidance Note)

# High Level Policy Guidelines for SME Finance

- Ghada Teima<sup>4</sup> -



## INTRODUCTION

The primary role of regulators is to ensure the efficient regulation and supervision that is essential to a well-functioning economy and that underpins economic, social and environmental objectives. Regulation that is properly designed and implemented helps the financial system to function as intended. An enabling regulatory framework and a supportive financial infrastructure are essential in the medium term to encourage sustainable, viable and significant improvements in access to SME finance.

In the short term, more direct public interventions may be merited, although these are not without risks in terms of market distortion. The optimal application of using public resources and the associated opportunity cost, have to be considered especially when public interventions are counter-cyclical or in addressing more structural market failures.

The capacity of governments to implement reforms, or regulators to effectively introduce and supervise new or reformed regulations, and of the financial sector to respond to an improved enabling environment will vary. While designing and enforcing an enabling environment and intervention mechanisms in support of SME access to finance, regulators need to keep overarching objectives in mind:

- Ensuring the stability of the financial system,
- Promoting financial literacy and consumer protection, and
- Respecting Anti-Money Laundering (AML) and Combatting the Financing of Terrorism (CFT) regulations.

In addition to the traditional role of ensuring the stability and efficiency of the overall financial system at large, regulators can contribute to greater access to finance by promoting a favorable legal and regulatory environment. Such an environment establishes the rules within which all the financial institutions, instruments and markets operate in a given country. This legal and regulatory framework is complemented by a sound financial infrastructure, which improves the efficiency and effectiveness of financial intermediation. A sound payments system and a well-functioning credit information framework are two essential elements of financial infrastructure. They are crucial to ensure the efficient functioning of financial systems.

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

Against this background, the World Bank Group has been a technical advisor and implementing partner for the G20 Global Partnership for Financial Inclusion (GPMI), which has declared its commitment to improving access to financial services for the poor and, among others, has established an SME Finance Sub-Group for that purpose.

<sup>4</sup> Ghada Teima is Lead Financial Sector Specialist in the Finance and Markets Global Practice of the World Bank Group and has been leading the WBG's G20 GPMI SME finance technical contribution since 2010..

## OBJECTIVES OF THE SME FINANCE POLICY GUIDE

Since the G-20 GPMI was launched, financial inclusion has been elevated to a permanent priority within the G-20. The SME Finance sub-group, with the support of the World Bank Group, produced the stocktaking report “[Scaling up SME Access to Financial Services in the Developing World](#)” in 2010. The report included 164 case studies and made policy recommendations in three broad areas:

- Legislation, regulation and supervision;
- Financial market infrastructure; and
- Public intervention and support mechanisms.

The G-20 SME Finance sub-group, with the leadership of the World Bank Group and support of development agencies and private sector players, committed to supporting the development and implementation of these SME Finance policy recommendations, through an [SME Finance Policy Guide](#). A policy guide for SME finance has therefore been prepared by the SME Finance sub-group, informed by further research, consultations and expert inputs. It provides a comprehensive set of good practice policy measures, recommendations, standards and guidelines, lessons learned and example models.

## APPLICATION OF THE SME FINANCE POLICY GUIDE

The Policy Guide sets out models and accepted or emerging good practice for policy and legal reforms and public interventions to support SME Finance. As such, it can underpin the development of country action plans and national strategies to improve SME access to finance. Given the mixed results achieved by SME finance policies, reforms and interventions in many countries, the Policy Guide incorporates lessons learned, outlines good practice models and places each Policy Guide component in the context of the issues that it can address, thus offering the potential for tailored, more cost-effective and higher-impact reforms and interventions. It also highlights the importance of data, where a lack of harmonized definitions, standardized data collection and indicator construction lead to challenges with comparability of indicators over time and across

countries which is especially true for SMEs, active versus dormant accounts and demand-side data.

## HIGH-LEVEL SME FINANCE POLICY GUIDELINES

Cross-cutting policy strategies to enhance SME access to finance are needed to provide a coherent framework for government actions in this area and within the broader policy ecosystem for SMEs. Such strategies are instrumental to define specific policy objectives; to design, coordinate and implement policy measures; and to provide a framework for monitoring and evaluation. They could be summarized in five main categories:

### I. Implementation of Sound Regulatory and Supervisory Frameworks

- The role of regulators: through financial inclusion strategies or commitments; openness to considering innovation; enforcement of consumer protection measures; careful attention to proportionality in measures to maintain the safety and soundness of their financial systems; and effective monitoring and supervision of expanding SME finance provision, based on improved data and capacity.
- Enabling regulatory frameworks for alternative SME finance products such as leasing, factoring, etc.
- Competition: Financial sector liberalization and banking regulations that allow the entry of sound and efficient banks and other types of financial providers; a legal and regulatory framework that promotes the development of alternative lending technologies, as well as the development of securities markets and institutional investors as an alternative to bank lending; greater transparency and more information dissemination about the pricing and conditions of banking products.
- Financial literacy and a consumer protection agency that watches out for evidence of anticompetitive behavior of banks and takes the matter up with the competition authority.
- Efforts to improve the scope, access and quality of credit information among banks, which would level the playing field between large and small banks.

- Complementary prudential regulation, and coherence between competition policy and regulation in the financial sector, to minimize any potential destabilizing effects from increases in competition.

## II. Development of Financial Infrastructure

Financial infrastructure should be a priority in the financial development agenda of most developing countries, as it can lower the costs and risks to financial institutions of serving SMEs, open the way for more modern and efficient lending techniques and expand the proportion of SMEs that can viably be served. A sound financial information infrastructure should improve transparency and disclosure for SMEs in a cost-effective way to help SMEs build a credit history, which is critical in helping to address both challenges of information asymmetry and the cost to service this sector. Sound financial infrastructure includes:

- Secured Transactions;
- Insolvency Regimes;
- Credit Information Systems;
- Payment Systems; and
- Accounting and Auditing Standards for SMEs.

## III. Design of Public Sector Interventions

Design public programs for SME finance which ensure additionality, cost effectiveness and user-friendliness, for example:

- For state-owned banks to play a positive and complementary role in the provision of credit to SMEs;
- Apexes and other wholesale funding facilities;
- Partial Credit Guarantee Schemes; and
- Government Procurement from SMEs and encouraging timely payments in commercial transactions and public procurement.

## IV. Promotion of Capacity Building Programs

Capacity building programs are designed to enhance the capacity of both SMEs, with regard to their management and financial skills, as well as to enhance the capacity of financial institutions to go “down market”.

## V. Consider Data as a Way to Prioritize Interventions and Measure Impact

Harmonize indicators and consistently collect SME finance data and monitor and evaluate SME finance policies to measure impact and feedback into new policies.

As a final note, knowledge sharing across countries and institutions to replicate and scale up successful development interventions in the SME finance space is important through a collaborative effort implemented by bilateral and multilateral development finance institutions and/or by establishing knowledge sharing platforms.





# INNOVATIONS IN FINANCING SMEs



The world of finance has changed dramatically since the global financial crisis of 2007-2008. Most prominent of these changes has been the rapid growth of finTech companies, solutions and platforms. Several factors have contributed to the very rapid evolution of finTech. Firstly, in the aftermath of the financial crisis, banking regulators imposed more controls and oversight over banks, resulting in more stringent lending guidelines. Banks have also been deleveraging away from lending activities which are perceived to be more risky. Secondly, interest rates in North America and much of Europe and Japan have fallen close to zero (or even below) offering investors little return on the placement of deposits in the banking system. Thirdly, there are entrepreneurs seeking less cumbersome and less bureaucratic borrowing channels – as they simultaneously seek a lower cost of funds. These developments, alongside the rapid rise of digital finance and digital platforms have opened up considerable opportunities outside of the banking sector – with very real possibilities for SME borrowers who, in any case, have been squeezed further out of the banking sector in many countries.

This rise of finTech lowers costs for financial intermediaries to receive information and data about clients, provides alternative channels to reduce service delivery costs (cell phones, cards and internet) and facilitates SMEs to better manage their businesses through real-time, affordable services. It helps diversify data that is used to determine SMEs creditworthiness and looks beyond bank credit to non-bank debt, and even non-financial data on borrowers. Finally, information and communications technology (ICT) is improving our understanding of the role different long-term instruments play (such as guarantees, asset-backed

and asset-based structures), how they are used and what opportunities and challenges they pose for SME financing. In other words, finTech has enabled emerging markets to leapfrog some developed markets to create unprecedented financing products and innovative approaches to financial issues.

In traditional finance, developed economies generally bring experiences to emerging markets. finTech opens up the possibility for developed countries to learn about innovations, such as digital finance or mobile banking, from emerging economies. Indeed, in terms of digital finance, some countries in Africa are already playing a leading role.

Possibly the two best known forms of finTech are digital finance and crowd funding. The former has been the subject of recent research undertaken jointly between the World Bank Group (World Bank) and the World Economic Forum (WEF) and holds great promise in terms of access to finance and financial inclusion. Models such as M-Pesa in Kenya, B-cash in Bangladesh and G-cash in the Philippines are well known for their considerable outreach and ease with which they have facilitated money transfers. Such digital payment systems are also important for SMEs in terms of information and business opportunities. As M-Pesa in Kenya has amply demonstrated, an increasingly long list of “M-companies” can be spawned on the back of M-Pesa payments modalities. Companies such as M-Shwari and M-Kopa are respectively taking micro finance and electricity the last mile – generally on the backs of SME providers.

Digital platforms are also important in that they are providing an increasingly larger electronic information base upon which future decisions, including financing decisions, can be made. The role of digital finance in expanding the electronic

footprint of SME firms is one extremely important way of helping to deal with the asymmetries of information that most of these enterprises face. Big Data and the use of increasingly sophisticated algorithms are constantly opening new and exciting business opportunities. Supporting increased use of digital finance for SMEs is therefore a high priority.

Crowd funding and peer to peer (P2P) lending has also taken off in a spectacular manner over the past decade on the back of digital platforms. Moving from donation crowd funding, to debt crowd funding and into equity crowd funding, the industry is evolving rapidly and growing fast. The potential to meet the financing needs of SMEs would also appear to be considerable. However, while offering great opportunities, it also comes with great risks, particularly on the regulation front. While most crowd funding appears to be taking place currently in China, the UK and the US, there have been very different models of oversight – from very little regulation to more formal oversight. The challenge is to encourage financial innovation while ensuring prudent oversight of a fast growing financial industry.

Data on the crowd funding industry is poor, with broad estimates that it may (in mid-2016) amount to a \$150 billion global undertaking, and is doubling every 9 to 10 months. While the total amount of funds involved is still dwarfed by the rest of the financial sector, the growth rate is impressive and the industry deserves serious and careful consideration. Regulatory concerns have been accentuated by recent unchecked activity in China where fraudulent activities have resulted in a considerable amount of money being lost by some investors. This in turn has spurred a greater interest in regulatory oversight mechanisms.

In addition to digital finance and crowd funding, other innovative and emergent forms of financing include: social impact bonds, development impact bonds, impact and social investing, psychometric testing, Big Data, block chain, bitcoin and others. Some early work has been initiated in some of these areas within the World Bank Group. The

first Development Impact Bond is currently being designed in Palestine to support a school-to-work transition project. A community of practice has also been established on block chain and bitcoin. However, more research, analysis and experimentation needs to take place from which the World Bank and others can learn and do more to adequately advise and support stakeholders with an interest in the growth of SMEs, from governments to banks to investors and to SMEs themselves.

The following four SME Finance Quick Lessons provide four very different approaches to innovative financing for SMEs from Asia, to the Middle East to the Caribbean:

- The first SME Finance Quick Lesson examines the possibility of mobilizing institutional investors into financing more of the SME market. While progress has been somewhat slow and uneven on this front – this Quick Lesson examines the potential for further development of capital market linkages for SMEs.
- While digital finance platforms are very well developed in some parts of the world – most notably in Africa – they lag considerably in the Middle East. In this second Quick Lesson, discover if Tunisia can provide a launch pad for increased digital financing in the MENA region.
- Angel and other early stage investors are increasingly important in the US, Canada, Europe and other parts of the developed world. In contrast, in many emerging countries they remain very nascent or even non-existent. The third Quick Lesson in this sections explores whether the establishment and growth of angel networks in the Caribbean can provide a replicable model elsewhere.
- The world has watched in awe as the crowd funding industry has boomed. Nowhere is this more so than in East Asia – with particular relevance for China. By some estimates, two thirds of all crowd funding takes place in China. But as illustrated in this Quick Lesson, it is not without its risks – as events in early 2016 have demonstrated.



# Mobilizing Institutional Investors to SME Financing

- Ana Carvajal and Tamuna Loladze<sup>5</sup> -



## 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 as 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 beyond banks. Capital markets and the institutional investors who invest through them are increasingly looking at alternative mechanisms that could help fill this gap. However, their potential and viability within the SME reality need to be carefully explored.

This note, a first in a series about capital markets and SMEs, summarizes the main lessons of the recently published WBG/IMF/OECD Report to the G20 on “[Capital market instruments to mobilize institutional investors for infrastructure and SME financing in emerging market economies \(EMEs\)](#)”. This note provides key takeaways as to the potential of different fixed income instruments to mobilize institutional investors to provide SME financing, and the challenges (and preconditions) for such mobilization to take place. The instruments analyzed included: bond issuances by SMEs, SME bond funds, bond issuances by SME lenders, covered bonds, SME securitization and SME debt funds. Future notes will 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 economies.

While the G20 Report (and this note) focused on fixed income instruments to mobilize institutional investors to SME financing, the role of equity financing, as well as retail investors both through equity and debt mechanisms will be explored in future notes.

## MAIN LESSONS AND TAKEAWAYS

The following summarizes the key takeaways about the potential of capital markets, and in particular institutional investors, to increase financing for SMEs in EMEs:

- Access to lending remains a key priority – 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 point of view (arms’ length perspective). 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. Thus, working to enhance SMEs’ access to lending should remain as a key priority for EMEs.
- Direct funding through SME bond issuances in capital markets remains more limited and suitable to larger, more formal SMEs. This is due to both supply-side and demand-side factors.

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- On the supply side, most SMEs, due to their small size and relatively informal nature, lack the capacity to prepare their businesses for a public offering of securities, which requires meeting a set of disclosure requirements on an initial and ongoing basis. Some avenues for fund raising, such as 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; investors 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 for investors to select and monitor individual SME deals which may not be worthwhile from an economic perspective. Finally, many institutional

investors have minimum risk rating requirements, which would be 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 advanced and EME markets, can help overcome the demand side challenges 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.
- Indirect funding through refinancing to SME lenders holds the largest potential to mobilize institutional investors to SME funding, initially through plain vanilla instruments and later through more complex structures, such as securitizations. Experience shows that institutional investors can play an important role in SME access to finance by providing financing to SME lenders (banks, microfinance institutions, factoring companies), which then ensure a steady flow of funding to SMEs, their ultimate beneficiaries.
  - In the short to medium term, such financing will likely take place via plain vanilla instruments – corporate bond issuances by SME lenders. Bank issuances are already the most common securities, 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 other SME lenders, however, may require credit enhancements to bring them to an acceptable risk-return level for 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 and thereby free up capital that could be used for generating new lending. 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.

## KEY CHALLENGES AND PRECONDITIONS

For many EMEs further development of the institutional investor base is the first precondition to realize the potential of capital markets to bridge strategic financing needs – 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.

## 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. 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 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, however, 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, 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.

Development of SME related capital market instruments also depends on the existence of a robust legal and regulatory framework within which the instruments could be created. In many countries there is already a framework in place for standardized instruments (bonds). 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 the existence of vehicles that allow ring fencing of assets. Yet having strong Special Purpose Vehicles (SPVs) that are bankruptcy remote is a challenge in many jurisdictions. In addition, clarity on the tax treatment of the assets transferred to the SPV is an important element. For covered bonds,



a dedicated legal framework with minimum quality standards and a clear definition of eligible assets that can be included in the cover pool is needed. For fund structures, a robust framework for closed-end funds is needed. Some of these more specialized frameworks are not yet in place or are incomplete in many EMEs.

Another supply-side challenge relates to the need to develop a streamlined securities offering regime for offerings targeted to institutional investors. Such issuance regimes reduce or eliminate disclosure requirements vis-à-vis the public 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. Introduction of such regimes in EMEs is thus also important to facilitate the offering of SME related instruments.

## DEMAND SIDE

Rigid investment frameworks in many EMEs can pose a challenge to institutional investors' ability to invest in SME related instruments. As explained above, SMEs themselves are not a natural fit for institutional investors due to their size; however pooling mechanisms can help overcome this challenge. Further, financing SME lenders constitutes a critical way in which institutional

investors can contribute to SME financing. While proper regulation of institutional investors is critical given their mandates and fiduciary duties towards their beneficiaries, some rules-based investment frameworks are overly prescriptive, thus limiting and sometimes prohibiting certain alternative investments, under which some of the SME instruments could fall.

Another challenge is the limited capacity of domestic institutional investors in many EMEs to analyze instruments beyond very basic products. This could be an issue for some of the potentially 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. 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.

## 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 financing gaps in strategic sectors, such as SMEs. Such policies should include an analysis of the potential role that capital markets in general, and institutional investors in particular, can have in bridging such financing gaps. 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.

Additionally, governments play an important role in the design of risk-sharing mechanisms (such as guarantees) to help align the risk-return appetite of institutional investors with existing financing needs.

Development institutions can support EME governments in the design and implementation of national strategies for addressing key financing needs. This includes providing advice, serving as an honest broker to help mobilize interest and build consensus, designing and offering risk-sharing mechanisms, structuring and underwriting instruments and participating in demonstration transactions with catalytic impact on market development.

## Mechanisms to Provide SMEs with Direct Access to Capital Markets

Type of instrument	Corporate bond issuances by SMEs			SME bond funds
	Issuances via private placement	Issuances via private placements to qualified investors	Issuances via public offerings in alternative markets	
<b>Supply side</b>	Small and medium size SMEs, with certain level of formality	Larger, more formal and more solid SMEs	Larger, more formal and more solid SMEs	Pipeline of bonds issued by SME companies
<b>Demand side</b>	Retail and potentially high net worth	Institutional and high net worth individuals	Mainly retail	Potentially all investors
<b>Securities markets framework</b>	Carve out from the public offering regime	Carve out from the public offering regime	Room for proportionate regulation in the public offering regime	Framework for CIS, in particular close-end funds
<b>Other supporting legal framework</b>	Framework for corporations	Framework for corporations	Framework for corporations	Potentially framework for SME markets, and/or private offering
<b>Disclosure requirements</b>	Typically none	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	In general it requires the same type of disclosure than a public offering in the official markets, but some adjustments are made, mainly: (i) the possibility to provide fewer years of financial information and use of local GAAP, (ii) periodic disclosure is required only semi-annually and (iii) deadlines for submission of reports are usually extended.	Depending on whether placed via public offering or not. For public offering, prospectus and periodic and ongoing information
<b>Corporate governance requirements</b>	No	No	Yes, for equity issuers. In general the requirements follow those of the official markets, but adjustments are made, in areas such as the number of independent directors and the type of board committees required; the thresholds for disclosure of material holdings and for take-over bids.	Governance of the CIS
<b>Framework for the institutional investors</b>	Must allow investment in securities of private offerings. Frameworks usually require a minimum rating for debt securities	Must allow investment in securities of private offerings. Frameworks usually require a minimum rating for debt securities	This is a typical investment; thus no need for any special treatment. Frameworks usually require a minimum rating for debt securities	In some countries, investment funds are treated separately. Thus the framework must allow this type of investments.
<b>Credit rating</b>	Typically no, as this offerings are not typically addressed to institutional investors	Usually required by institutional investors	Usually required for debt	Not necessary, but some EMEs require rating of CIS
<b>Taxation framework</b>	Typically no tax incentive	Typically no tax incentive	Some countries provide tax incentives	Requires taxation as a pass through

## Mechanisms to Refinance SME Lenders

Preconditions	Corporate bond issuances by SME lenders	SME securitization	SME covered bonds	SME loan and credit funds
Supply side	Banks, microfinance institutions, factoring and leasing companies	Pipeline of SME loans, with quality information	Pipeline of SME loans, with quality information	Pipeline of SME related assets, such as SME loans, trade receivables, with quality credit information
Demand side	Potentially all investors, but in particular institutional	Mainly institutional	Mainly institutional	Mainly institutional and high net worth
Securities markets framework	Usually nothing additional	Framework for securitization	Framework for covered bonds	Framework for CIS, in particular close-end funds
Other supporting legal framework	Depending on the issuer, legal framework for banks, factoring, leasing	Legal framework for SPVs	Nothing additional	Depending on underlying asset, framework for secured transactions, factoring or leasing
Framework for the offering	For public offering, prospectus and periodic and ongoing information, including at a minimum semi-annual reports with audited financial statements and material events	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	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.	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.
Corporate governance requirements	Not for the offering, but the respective institution might be subject to CG based on its own framework	Framework to address conflict of interest, including retention requirements and prohibitions of related party transactions	The covered bond law would have provisions related to the obligation of the bank to replace non performing portfolio	Governance of the CIS
Framework for the institutional investors	This would be a typical investment	Must allow investment in securities of private offerings. Frameworks usually require a minimum rating for debt securities	This is a typical investment; thus no need for any special treatment. Frameworks usually require a minimum rating for debt securities	In some countries, investment funds are treated separately. Thus the framework must allow this type of investments.
Frameworks usually require a minimum rating	In some countries, structured products are treated separately. The framework must allow investment on them	Usually required by institutional investors	Usually required for debt	Not necessary, but some EMEs require rating of CIS
Frameworks usually require a minimum rating	No experience in EMEs with the treatment of covered bonds. They would probably fall under the category of fixed income/corporate bonds	In some countries, investment funds are treated separately. Thus the framework must allow this type of investment.	Some countries provide tax incentives	Requires taxation as a pass through
Credit rating	Usually required	Usually required	Usually required	Not usual
Taxation framework	Typically no tax incentive	Require favorable treatment of the transfer of assets	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	Requires taxation as a pass through





# Promoting Financial Inclusion and Digital Finance in Tunisia

- Peter McConaghy<sup>6</sup> -



## INTRODUCTION AND CONTEXT

A critical challenge facing post-revolutionary Tunisia is implementing policies that will deliver higher growth, inclusion, and citizenship participation.<sup>7</sup> Tunisia's underdeveloped financial sector hampers efficient resource allocation and prevents greater investment and expansion of private sector activity. Financial intermediation in Tunisia is generally low and of poor quality, which translates into limited access to finance for households and micro, small, and medium-sized enterprises (MSMEs), and a resource allocation process skewed towards connected or over-collateralized firms at the expense of more productive investment projects. Recognizing this, the country's Ministry of Finance is preparing a financial sector modernization plan for 2015-2020<sup>8</sup> that outlines more than 20 areas ripe for reform, including financial inclusion – defined as the access and usage of financial services such as credit, savings, payment services, and insurance by households and businesses.

This Quick Lesson summarizes key findings from two pieces of recent analytical work on inclusive finance in Tunisia. First, this note synthesizes the [Tunisia Financial Inclusion Snapshot](#).<sup>9</sup> The snapshot consolidates available data and studies in order to facilitate debate and knowledge around financial inclusion challenges in Tunisia. Second, this note

highlights key findings from the [Tunisia digital finance survey](#)<sup>10</sup>, produced in 2015 by the World Bank and the Center of Arab Women for Training and Research (CAWTAR). The study assesses current usage and market potential for mobile financial services in Tunisia. The study consisted of 1,234 face-to-face 40 minute interviews and 11 focus groups, with a particular focus on low-income women and youth. The survey also examined the regulatory framework and financial infrastructure underpinning digital finance.<sup>11</sup>

## UNMET DEMAND FOR FINANCIAL SERVICES IN TUNISIA

Although Tunisia enjoys a well-developed postal network that provides affordable basic savings services to low-income populations, and has recently made regulatory reforms to its microcredit sector, the overall offer of inclusive financial services in Tunisia remains fragmented, incomplete, and difficult to access.

The 2011 [national microfinance strategy](#) estimated that around 30% to 40% of the adult population (2.5 to 3.5 million individuals), and more than half the enterprises in Tunisia (245,000 to 425,000 registered businesses) remained unserved or underserved by the mainstream financial sector. These two recent market studies corroborate these figures: the 2015 digital finance study found that two-thirds of adults

6 Peter McConaghy is Financial Sector Specialist in the Finance and Markets Global Practice of the World Bank Group.

7 [Tunisia - Systematic country diagnostic](#), World Bank Group, 2015.

8 Other key priority areas under this plan includes improvements to the supervisory and regulatory framework of the banking sector and financial sector diversification (capital markets, housing finance, etc).

9 <http://documents.worldbank.org/curated/en/2015/10/24865372/snapshot-financial-inclusion-tunisia-low-income-households-micro-enterprises>

10 <http://www.microfinancegateway.org/fr/library/services-financiers-mobiles-et-inclusion-financi%C3%A8re-en-tunisie-0>

11 Both studies were financed by the MENA Multi-Donor Trust Fund in the context of the Enhancing Microfinance Amongst Women and Youth Project.

## Estimated Demand for Microfinance in Tunisia<sup>12</sup>

		Demand for Microfinance	of which Microcredit
Individuals (including informal micro-entrepreneurs and businesses)	Active working population	~1.2 to 1.6 million	~0.5 to 1 million
	• Salaried private sector employees	~1,000,000	300,000
	• Business owners	0 to 425,000	0 to 425,000
	• Farmers	160,000	160,000
	• Public sector employees	90,000	30,000
	Partially active or inactive population	~1.2 to 1.5 million	~360,000
Unemployed	• Young adults/ Students	0 to 350,000	0
	• Inactive people	~1,000,000	360,000
	• Poor families	150,000	0
		100,000 to 700,000	100,000
	<b>Total private individuals</b>	<b>~2.5 to 3.5 million</b>	<b>~0.95 to 1.4 million</b>
Formal businesses	Micro-enterprises (revenues < 30 K TND)	213,000 to 395,000	
	Very small enterprises (revenues of 30 to 200 K TND)	30,000 to 32,000	
	<b>Total businesses</b>	<b>245,000 to 425,000</b>	

are excluded from or underserved by the formal financial sector and the [2014 Findex study](#) found that only 27% of adults reported holding an account with a formal financial institution. In addition, extensive qualitative research completed in Tunisia shows that low-income people have active financial lives but have to resort to informal financial services that may be both risky and costly.

Similarly, many enterprises have financing needs that are far from being met from the existing supply. It is estimated that 245,000 to 425,000 micro and very small enterprises require a specific range of financial services, equivalent to 37% to 65% of those registered in the national business registry (see table above). A [2014 IFC study](#)<sup>13</sup> estimated that approximately 15,000 small and medium-sized enterprises (SMEs) should be added to this figure. It found that only 15% of very small, small, or medium-sized enterprises (VSSMEs) have taken out bank loans whereas 58% have expressed the need for financing in order to make investments or for working capital. This gap may be explained by a number of inefficiencies in the financial system, such as bankruptcy procedures,

the underdeveloped credit guarantee system, a lack of genuine competition between banks, and the under-utilization of credit bureau information.<sup>14</sup>

Quantifying this demand was based on secondary sources and gives rise to the possibility of significant margins of error, since the data is 5 or even 10 years old. Tunisia currently lacks the data required to properly understand the market demand for financial services and hence create appropriate financial inclusion policies and conducive legislative frameworks.

### CURRENT SUPPLY OF FINANCIAL SERVICES IN TUNISIA

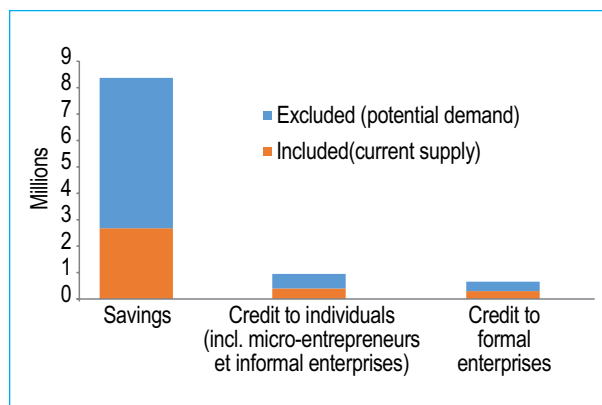
Existing supply in Tunisia has not adapted to existing demand, with many people using informal services for savings and credit (see figure on page 33). Banks have low portfolio quality: about 15% of loans are in arrears and the banks lend primarily to salaried workers; in 2013, there were about 16 billion TND (7,265 billion euros) in outstanding loans spread across 1.3 million borrowers, according to the Central Bank. About 338,000 businesses were financed in 2013.

<sup>12</sup> Source: Coordinated Vision, Tunisia Finance Ministry, 2011; Financial inclusion study, MicroMED, 2014.

<sup>13</sup> [Market Assessment of the Financial Needs of Very Small, Small, and Medium Enterprises in Tunisia](#), published by IFC (2014);

<sup>14</sup> Evaluation of the Business Climate in Tunisia, World Bank Group, 2014.

## Comparison between Potential Demand and Current Supply of Savings and Credit in Tunisia<sup>15</sup>



The majority of financial institutions consider the very small, small, and medium enterprise (VSSME) segment of micro-financing, risky and opaque. The 2014 IFC survey found that people working in 29% of the VSSMEs it examined had never attempted to open a bank account; 37% reported needing financing but had never contacted a financial institution; 78% used cash to pay their suppliers, and 91% used cash to pay their employees.

The postal savings account network is almost as extensive as that of the entire banking sector and far more evenly spread across Tunisia; in 2014, it had 1,051 branches. It is thus a key player when it comes to financial inclusion. But it has only 178 ATMs, and a quarter of its branches are not connected to a central server. They also have relatively limited opening hours and strict minimum payments, making the network difficult to use for micro-savings requiring regular withdrawals and very small deposits. Over 50% of the 5.5 million postal accounts are inactive, with no transactions having been made for the past two years or longer.

## LEGAL AND REGULATORY FRAMEWORK

The regulatory framework for inclusive finance in Tunisia includes a microfinance law and a central bank circular aiming at promoting mobile payments. The Table below provides an outline of supervisory structures. In 2011, legal reform laid the foundation for the development of the microfinance sector, authorizing new actors as associations and limited liability companies, and creating a modern regulatory agency (the microfinance supervisory authority). In the past 12 months, authorizations have been granted to four newly-created companies (Taysir, Microcred Tunisia, Advans Tunisia, and the Entrepreneurship Financial Center). Given this sectoral expansion, microfinance institutions (MFIs) are set to play an important role in financial inclusion in Tunisia.

### Supervision of Financial Institutions by Type

Banks <sup>16</sup>	Central Bank of Tunisia
Tunisian Post Office	Ministry of Telecommunications
Microfinance institutions	Microfinance Supervisory Authority (ACM)
Insurance companies	General Insurance Committee (Comité Général des Assurances), under the supervision of the Ministry of Finance

## DIGITAL FINANCE LANDSCAPE IN TUNISIA

Tunisia is a country that has all the necessary ingredients for digital financial services (DFS) to take off. Forty-three percent of the working-age population is under 30 years of age, there is a mobile penetration rate of 118% – and 98% of Tunisians have completed primary education.<sup>17</sup> Yet despite the compelling evidence that digital financial services offer huge opportunities to expand financial inclusion by reducing costs, improving user experience, and reducing proximity barriers,<sup>18</sup> less than four percent of Tunisians use mobile financial services.

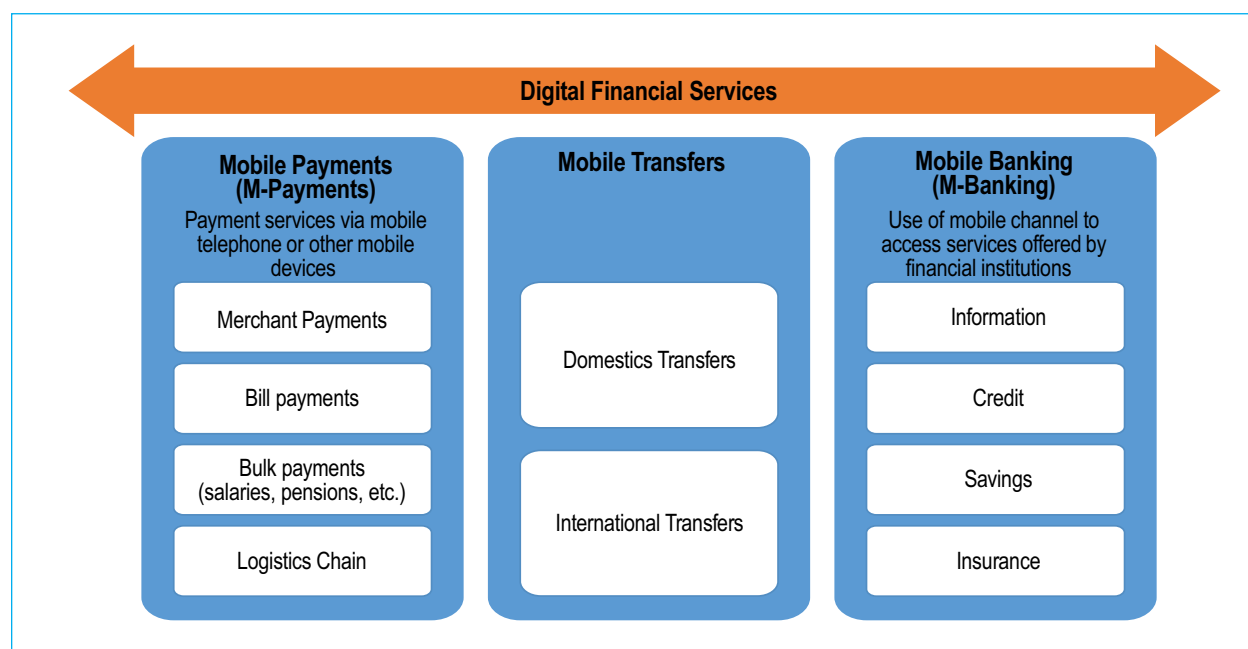
<sup>15</sup> Note: The total market is estimated as follows: 1) Savings: total = adult population or 8.4 million individuals; 2) Credit to individuals = estimate of 950,000 for microcredit only (2014 study); 3) Credit to formal enterprises = all businesses in the national registry RNE (654,200 in 2013). Further studies are required to better quantify the numbers and relevant amounts, especially for credit.

<sup>16</sup> Including the Tunisian Solidarity Bank (BTS) and leasing companies.

<sup>17</sup> Data taken from [World Bank World Development Indicators](#).

<sup>18</sup> For more on the conceptual links between digital finance and development, see: [In the Fast Lane: Innovations in Digital Finance](#), Bull, Great and Parada, Marcia, International Finance Corporation, 2014.

## Overview of Digital Financial Services

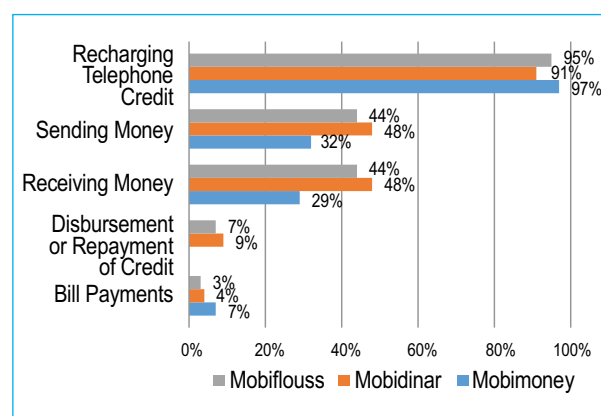


The regulatory framework for digital finance in Tunisia is bank-led, and falls under the supervision of the Central Bank of Tunisia (CBT). Partnerships between banks and non-bank financial institutions (NBFIs) may be authorized, notably in order to facilitate the opening of electronic wallets and the implementation of networks to purchase or sell electronic money. In practical terms, implementation of these partnerships remains difficult. To date, only one has emerged (BIAT/Via Mobile for the m-Dinar service) and has seen little uptake. The four services currently in the market (the three postal services – MobiFlouss, MobiDinar, and Mobimoney – and the m-Dinar service) offer limited services and lack interoperability. There are, however, several projects underway led by either mobile network operators, the Tunisian Post, or the government, which could change the digital finance landscape in Tunisia.

Approximately 400,000 individuals in Tunisia use DFS, less than 4% of the population. Users are generally youth (95%) and live in urban and peri-urban areas (95%) and to a large extent are students (84%) who have subscribed to postal services to receive education transfers. Services

are limited generally to re-charging air-time (90% of respondents) and transfers (40% of respondents). The amount transferred is generally very small (~ 40 TND/~20 USD per transfer). Only 3% of respondents use DFS to pay bills. DFS have allowed 60% of the 400,000 users to become banked<sup>19</sup> – only 40% of respondents were financially included prior to signing up for key services. 57% of respondents estimate that DFS have had a positive impact on their lives, notably due to gains in time (see figure below).

### Uses of Digital Financial Services in Tunisia



<sup>19</sup> Subscribing to digital financial services requires opening an account or a prepaid card in Tunisia.

The full expansion of DFS in Tunisia is constrained by a number of key factors. These include the significant distance between cash-in and cash-out points, lengthy wait times to complete procedures (50% of respondents reported a transaction can take upwards of one hour to complete), a lack of understanding of product features, the lack of interoperability between providers, and product feature limitations (e.g. money transfers limited to once daily). DFS is also constrained by a lack of communication surrounding the product (90% of those surveyed who were non users of DFS had never even heard about DFS.), a general preference for cash amongst low-income segments, and a lack of confidence in new services.

In order to promote the sustainable expansion and use of DFS in Tunisia, market players should focus on the following five key recommendations:

1. Extend the range of digital financial services beyond transfer and airtime recharge.
2. Improve distribution: increase the proximity of key cash-in/cash-out points to customers (particularly for the most vulnerable in rural and lagging regions); Distribution points should promote security, proximity and ease of use.
3. Educate customers on product features and improve the customer experience (affordability/usability)
4. Ensure interoperability: users of digital financial services must be able to perform transactions with customers and point of sale/ ATMs of other banks as well as with customers using products launched by NBFIs.

## LOOKING AHEAD

The opportunities for financial inclusion in Tunisia are significant. There are, however, a number of structural and short-term challenges to overcome. Expanding beyond micro-credit to develop savings, micro-insurance, and payment services will require:

- Identifying a high-level advocate for financial inclusion;
- Coordination on a national financial inclusion strategy;
- Conducting a thorough market study to obtain nationally-representative and up-to-date data on market characteristics;
- Clarifying the role of different public and private actors in the market (e.g. Tunisian Post, banks, MFIs, mobile network operators); and
- Developing a robust consumer protection framework to manage sectoral growth and address ongoing challenges.



# Innovative Early Stage Financing in the Caribbean: A2F Business Angels Project

- Aun Rahman and Jeremy Bauman<sup>20</sup> -



## INTRODUCTION

Economic growth in the Caribbean countries has been losing ground continuously compared with the Latin American region and other small economies in the world. Caribbean GDP grew by an average of just 1.1% in 2014 and 1.7% in 2015. Underlying the Caribbean growth gaps are low levels of productivity and competitiveness.

According to the World Economic Forum's (WEF) Global Competitiveness Report, Caribbean regional productivity continues to be low and trails other emerging economies, which is mainly attributable to weak public institutions and a poorly performing private sector. In the WEF report, six of the seven Caribbean countries included were ranked in the bottom 50% of the 144 economies covered by the study, and only Barbados, at 55th, was placed in the upper half of the world rankings.

A major constraint to growth in the Caribbean is a deficit of innovative firms, which are likely to be key job creators. According to the Global Entrepreneurship Monitor, in all of the Caribbean countries, less than 40% of enterprises have products or services that are considered innovative.

Compared to other regions, Caribbean enterprises have weak growth prospects: less than 1.6% of Caribbean enterprises have created more than 20 jobs in the last three years, and less than 20% will grow to have more than 20 employees in five years.

Meanwhile, access to finance is a principal challenge faced by Caribbean enterprises. Access to finance refers to the ability of firms to obtain the capital necessary to launch, develop and grow businesses.

In developed economies, traditional businesses with hard assets typically use bank loans or private investment. However, data from a 2014 firm-level survey by the Inter-American Development Bank show that 30% of firms in the region consider it a moderate obstacle and 26% cite it as a major or severe obstacle to growth. Few financing options are available for start-ups and early-stage enterprises in the Caribbean, as commercial banking loans are difficult to secure due to the cash flow and collateral requirements of banks.

Venture capital and private equity activity, particularly with respect to early-stage companies, is virtually non-existent.

Angel investing - which involves high-net-worth individuals investing their own capital and time in start-up and early-stage businesses - has the potential to emerge as an effective and relevant form of capital for innovative start-up and early-stage Caribbean firms. Angel investing brings significant advantages to innovative firms, and could play a foundational role in the Caribbean entrepreneurial financing ecosystem.

## THE INTERVENTION

InfoDev's Access to Finance (A2F) initiative under the Entrepreneurship Program for Innovation in the Caribbean (EPIC) aims to unlock appropriate sources of capital for Caribbean businesses, with the principal focus being the development of angel investing as a viable source of financing for innovative enterprises.

<sup>20</sup> Aun Rahman is Financial Sector Specialist and Jeremy Bauman is Consultant in the Trade and Competitiveness Global Practice of the World Bank Group.

While informal angel investing by individuals is common around the world, and is present in the Caribbean, organized angel investing offers advantages for both investors and entrepreneurs. Organized groups allow investors to benefit from the collective wisdom, experience and professional networks of their fellow investors while enabling members to access expanded deal flow, to share the due diligence workload and to spread financial risk across more investments. For entrepreneurs, angel groups can be an accessible, transparent and valuable form of capital – and can be one of the only sources of available capital.

Angel groups typically function as investor clubs, where a leader (champion) brings together like-minded professionals interested in entrepreneurship and alternative investing. More organized groups have managers who oversee group operations, source investment deal flow and help prepare entrepreneurs for presenting to the group, while others are member-led. Depending on the structure, managers and members can drive due diligence, negotiate investment terms and facilitate the transaction, pooling capital together from members. In less formal “networks,” members pursue investments individually.

Although the A2F initiative is in its early stages, progress over the last 12 months has demonstrated that there is a willingness by local high net worth individuals in the Caribbean to invest, and that there is significant demand from entrepreneurs. The note that follows outlines some of the key features and achievements of the intervention, the challenges faced and implications for the way forward.

## THE APPROACH

The project team adopted a demand-driven approach based on the needs of investors to facilitate organic development of local angel groups rather than a one-size-fits-all strategy that prescribed models based on US or European practices.

In a region with diverse business and social constructs, it was theorized that each group would develop its own identity and operational model in response to the personalities, motivations, professional backgrounds and interests of members.

In addition, infoDev brought in global practitioners, including successful angel investors and group managers, to lead on-the-ground activities.

The project follows an implementation framework heavily focused on technical assistance and mentoring, which includes:

- 1. Identifying “champions.”** Champions are generally successful, well-connected businesspersons with strong leadership characteristics and convening influence who serve as group figureheads.
- 2. Training and mentoring managers.** The group manager is a critical role to the daily operations of the group, as they are tasked with administrative and operational responsibilities, investment sourcing and driving the due diligence and investment processes.
- 3. Guiding group formation.** Membership policies, meeting schedules, investment theses and due diligence processes are structured with input from leaders and early members.





4. **Experiential training.** Technical training on term sheets and working through the transaction processes is provided real-time rather than in “academic” settings.
5. **Sustaining operations.** Groups require overhead to run effectively. All of the Caribbean groups charge membership dues to partially cover costs, and some have additional donor or grant funding.

## ACHIEVEMENTS AND LESSONS

As of May 2016, three organized angel groups have been established in the Caribbean: Trident Angels in Barbados, and First Angels (Kingston) and Alpha Angels (Montego Bay) in Jamaica. The groups collectively have over 60 members and each has designed initial operating models, developed investment sourcing and due diligence processes and is currently meeting on a scheduled basis and actively reviewing enterprises for investment consideration. Since their forming, 26 entrepreneurs have pitched, 17 companies have been taken forward for due diligence, eight term sheets have been issued and four deals have been closed for approximately US \$350,000.

### Motivations of Caribbean Angels

Globally, high net worth individuals (HNWIs) rank financial returns high on their list of motivations for getting involved in angel investing, though most HNWIs also have social and intellectual interests for getting involved, from supporting entrepreneurs to seeing the latest technologies in trending fields. The angel investors now emerging in the Caribbean as a result of this project, while still being commercially motivated, are significantly socially driven. They have a genuine desire to “give something back” to their local communities by mentoring and guiding aspiring entrepreneurs. Because of the nascent nature of the entrepreneurial ecosystems in the region, particularly as relates to technology companies, many Caribbean angels view angel investing as a form of “venture philanthropy,” and most are prepared for modest returns, or even losses, provided that they are contributing to the growth of a new class of entrepreneurs and more dynamic economies in their home markets. Additionally, they are aware that businesses need more than just capital to grow, and that as successful, influential



leaders within their business communities they bring much more than their checkbooks to the table.

An additional reason why Caribbean angel investors are joining groups is accessing new deal flow through expanded networks, and the groups have expressed a willingness to look across the region for opportunities, not just their home islands. Furthermore, members are seeing that aggregating capital allows them to spread their personal funds across more investments, providing better portfolio diversification.

### Investment Trends

While it is too early to draw conclusions around investment preferences or types of deals that will be completed in the region, some early trends are emerging.

- **Investment Thesis**

The makeup of an angel group, including the backgrounds and demographics of members, heavily influences the investment thesis for each group. For instance, Alpha Angels (AA) members are generally younger (mid-30s to mid-40s), which may impact the types of companies that appeal to the members, their motivations to invest and investment size. The AA’s manager noted, “Our members are younger and want to see products and entrepreneurs that are cutting-edge, fresh, cool and marketable.”

- **Investment Value and Investment Instruments**

The investment range is naturally a factor of the size of the group membership base and the source of capital (personal or corporate funds). Investments closed have ranged from US \$45,000 to US \$150,000 and conversations with the groups suggest that there may be capacity to go up to US \$250,000 per deal, though smaller amounts are likely to be more common. Most angels interviewed expressed a preference for equity investing, but with support from the infoDev team, have explored the viability of alternative investment structures.

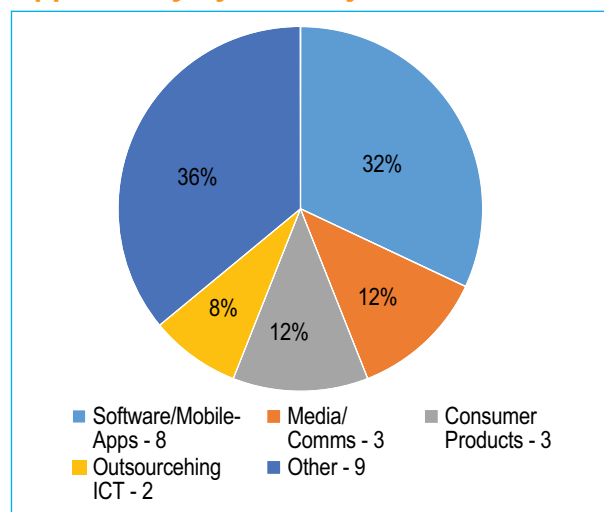
- **Alternative Approaches**

In two instances, a group has tabled an “equity for service investment” that would result in equity transfer or dividends to the investors based on value gained (revenue-derived) through network introductions that lead to new business, for example. In this case, the lead angel noted, “the company has high margins and a sound business model. They don’t need capital to grow, they need contacts.” How such arrangements will play out will be interesting to monitor, and potentially significant for regions where angel investing is new and liquidity is limited.

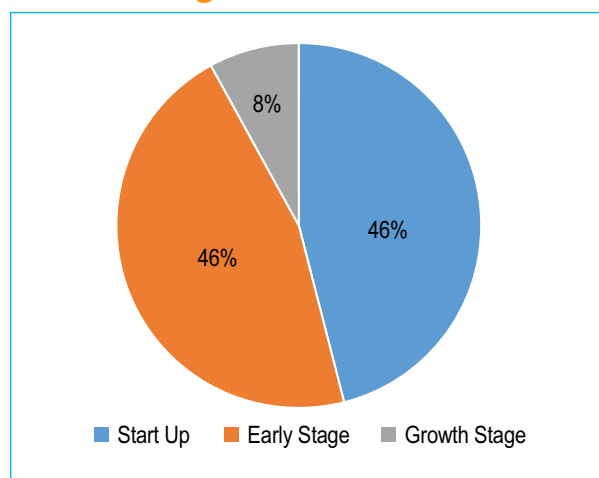
### Industry and Investment Preferences

The following tables present a breakdown of the companies that have presented in front of angels at group meetings, by sector.

### Opportunity By Industry



### Business Stage



- **Pan-Caribbean Investing**

Recognizing that home markets present potentially limited investment opportunities, particularly on smaller Caribbean islands, all three groups have expressed an interest in pursuing Pan-Caribbean investing. Two groups have signed an MOU, prepared with infoDev assistance, to outline protocols around deal sharing.

- **Non-capital Value of Angels (mentoring)**

All groups have also been providing non-financial assistance to entrepreneurs in the form of networking connections, pitch/investor engagement assistance and the constructive value that comes from meeting with angels in group meeting settings. In many ways the input now being provided by these highly experienced business people may be regarded as of significantly greater value to the companies than cash from investors with less relevant direct industry experience.

### CHALLENGES

While the progress of the three groups is encouraging, the organized angel investing community remains at a nascent stage, susceptible to local market conditions. The main challenges, expressed by the three groups themselves, are as follows:

- ***Need for Higher Quality Deals***

Group angel investing depends on good deal flow - without interesting companies and exciting investment opportunities, enthusiasm can quickly dissipate. As such, building a strong investment pipeline is paramount to group sustainability. While business plan competitions, incubation programs and entrepreneurship programs at universities assist ideation and entrepreneur community-building, they are in some ways longer-term contributors to deal flow, as the products are often concepts or little more than business blueprints.

- ***Limited Precedent for Private Equity Investing***

Most entrepreneurs in the Caribbean have never considered giving up ownership in exchange for a financial investment. Magnifying this reality, entrepreneurs are unfamiliar with the expectations of investors, and often go into conversations unprepared for the investor mentality. This poses obstacles when it comes to topics such as management oversight and governance, as entrepreneurs are reluctant to give up ownership and valuation, as realistic and agreeable valuations based on future potential are challenging.

- ***Investor Engagement***

In a region where angel investing is new, it is no surprise that entrepreneurs lack knowledge on how to engage investors. While many have been coached in business plan pitching, the expectations of investors surprise many entrepreneurs, who often have not thought through topics such as shared ownership and an exit. As a result of the infoDev intervention, the likes of the Branson Centre in Jamaica and the Caribbean Export Development Agency are now introducing elements of investor engagement into their entrepreneurial trainings. A2F has also been involved in a series of “Investor Engagement Workshops” in Jamaica, St Lucia, Belize and Barbados.

- ***Entrepreneur/Investor Trust***

Many Caribbean entrepreneurs characterize investors as merely self-interested individuals, and investors are often stigmatized as being greedy and untrustworthy. As a result, entrepreneurs tend to be tentative about approaching investors, and are reluctant to share perceived proprietary information regarding their businesses. Only once there are examples of successful deals, having the entrepreneurs act as vocal advocates, will the issue be addressed.



## LOOKING AHEAD

During FY16, infoDev A2F designed and performed stage-setting activities for the launch of the Caribbean Investment Facilitation Program (CIFP). With the goal of leveraging the grant funds to greater impact, A2F intends to encourage and enable entrepreneurs to raise private investment, namely from angel investors, through grants and non-financing activities.

The CIFP will be a US \$1.6M project delivered through a Caribbean-based partnering agency with a Pan-Caribbean reach and strong private and public networks. The program will have three core components:

- 1. Grant Financing.** Grant funding will be available to entrepreneurs via two sub-grants.
  - Co-Investment/Matching Grants will provide grant funding of up to 50% of the private capital raised to start-up, early and growth-stage enterprises that have secured investment from angels or other “approved” investors.
  - Investment Readiness Grants will involve grant funding to start-up and early-stage enterprises that show strong business and investment promise but are still

not considered “investment ready” by investors. The purpose of these grants is to prepare companies for angel investment within a short time frame by providing “pre-investment” funding that improves the prospects for investment.

- 2. Investor Network Building.** The CIFP design emphasizes activities that promote early-stage investing in the Caribbean, including strengthening communications between existing groups and pursuing the build-out of a Pan-Caribbean angel network. In addition, new group formation will be ongoing in locations such as Trinidad, Suriname and Belize.
- 3. Deal Flow Cultivation.** The CIFP will aim to develop an expanded deal-flow base and will test the use of an online platform to increase the pipeline of opportunities while facilitating introductions between entrepreneurs and investors. In addition, CIFP will carry out investor engagement activities for high-potential entrepreneurs to get training on effective fundraising.

Ultimately, the CIFP should form the focal point for early-stage investing in the region, and will serve as the coordinator for regional angel activity that includes collaboration between all angel groups.

# Crowdfunding in East Asia and the Pacific

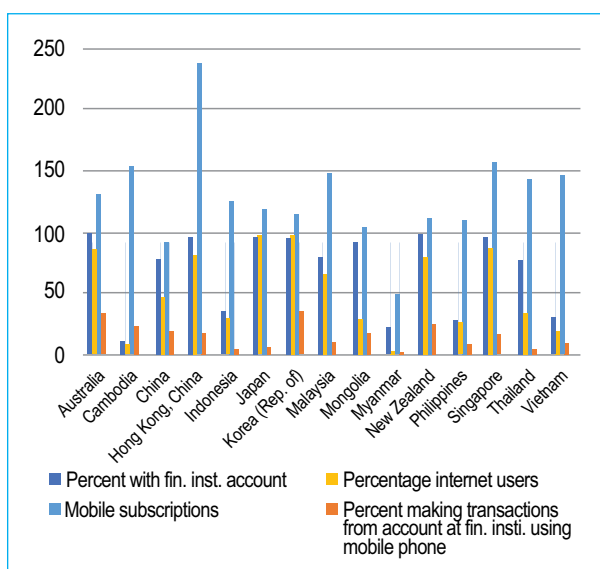
- Margaret Miller<sup>21</sup> -



Financial services may be the next major industry to experience a tectonic shift in how products and services are delivered and how value is created. Disruptive technologies, enabled by the internet and spread of cell phones, are creating new business models every day. Crowdfunding, or marketplace finance, which includes peer-to-peer (P2P) lending, is among the fastest growing segments of alternative finance.

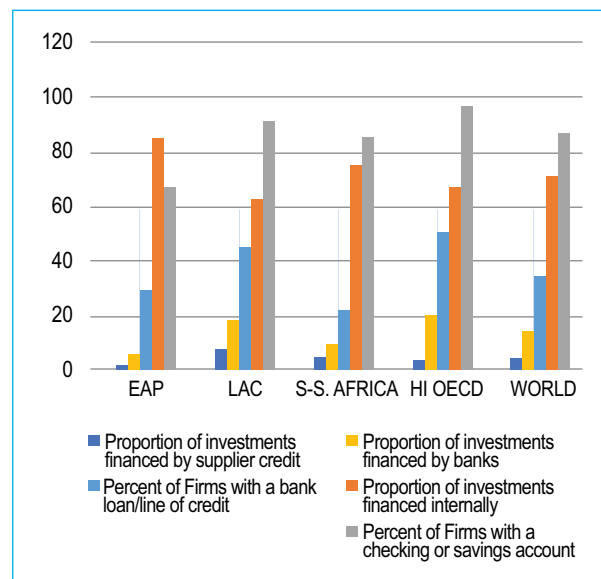
There are many reasons to think that East Asia and the Pacific could be at the forefront of the crowdfunding revolution. The region is advanced technologically, with a high level of mobile phone penetration and internet access, widespread use of social media and electronic commerce, and local IT manufacturing and software capability; all of which are paying the way for increased internet-enabled financial activity (see Figure 1).

**Figure 1 - Mobile Phone, Internet, and Financial Account use in EAP**



On the demand side there are also multiple factors contributing to the growing popularity of crowdfunding, starting with the unmet demand for finance by MSMEs. As shown in Figure 2, firms in EAP are currently obtaining far greater levels of financing for investments from internal funds than from banks. In fact, firms in EAP have an even lower proportion of investments financed by banks and supplier credit than is the case in Sub-Saharan Africa, according to data from the World Bank Enterprise Surveys. In terms of consumer finance, other demand side factors include a growing demand for credit to support increased consumption, and for a rapidly aging population, a desire for new instruments offering greater returns on investments than are currently available through banks and other traditional financial institutions.

**Figure 2 - Sources of Firm Finance (WBG Enterprise Survey Indicators)**

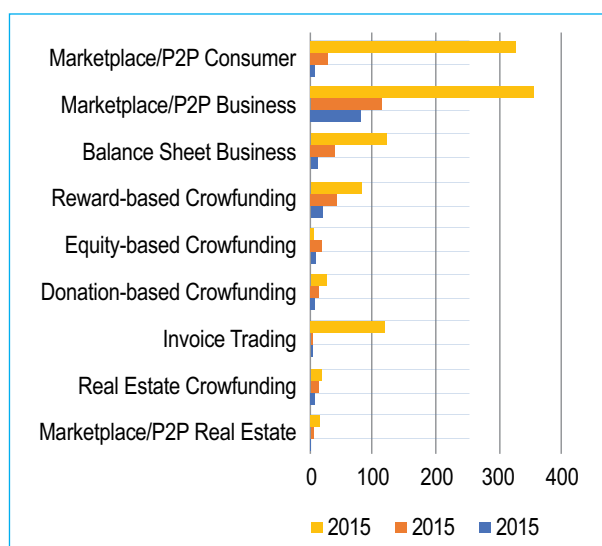


Source: World Bank Enterprise Surveys

21 Margaret Miller is Lead Financial Sector Economist, in the Finance and Markets Global Practice of the World Bank Group.

Crowdfunding offers a new way to bridge some of the distance between demand and supply for credit in the MSME market. Crowdfunding, including Peer-to-Peer (P2P) is an internet-enabled way for businesses, organizations such as NGOs or individuals to raise money in the form of either donations or investments from multiple individuals.<sup>22</sup> (See the box at the end of this Quick Lesson for additional detail on the various types of crowdfunding.) Recent research conducted by the Cambridge Center for Alternative Finance shows the rapid growth of crowdfunding platforms operating in the Asia-Pacific region, covering both investment based and donation-based models (Figure 3). China is not included in these data as their crowdfunding activity is larger by an order of magnitude than the rest of Asia Pacific, amounting to an estimated US\$ 100 billion in 2015. Amongst the types of crowdfunding platforms surveyed by the Cambridge Center, marketplace/P2P business lending alone supplied US\$ 356 million in loans to SMEs in 2015<sup>23</sup>. While rapid growth shows the potential of this new approach, continued expansion will depend on the development of the legal and regulatory framework required for such transactions as well as strengthening the necessary financial infrastructure.

**Figure 3 - Volume of Crowdfunding in Asia-Pacific Excluding China, 2013-2015 (\$ Million USD).**



Source: The Cambridge Center for Alternative Finance, 2016.

22 Crowdfunding's Potential for the Developing World.\* Infodev, 2013, page 8.

23 Cambridge Center for Alternative Finance.

A specific legal and regulatory framework for crowdfunding is not yet in place in most emerging markets. The quality and focus of national legal and regulatory frameworks is one of the most important factors behind the ability of crowdfunding and other alternative financial methods to develop and provide a sustainable source of finance in East Asia. Crowdfunding is such a new activity that in many countries governments have not yet developed specific laws and regulations. However, the existing legal and regulatory framework for investments and business development provides a starting point. The table below illustrates the current state of crowdfunding within the legal systems of the EAP region.

Country	Is Crowdfunding legal?		Is there a specific regime that addresses crowdfunding?	
	Equity	Debt	Equity	Debt
Australia	Yes	Yes	Developing	No
Cambodia	Developing	Developing	No	No
China	Yes	Yes	Developing	Developing
Indonesia	No	No	Developing	No
Japan	Yes	Yes	Yes	No
S. Korea	Yes	Yes	Yes	Yes
Singapore	Yes	Yes	No	No
Laos	No	No	No	No
Malaysia	Yes	Developing	Existing	Developing
Mongolia	Yes	Yes	No	No
Myanmar	No	No	No	No
New Zealand	Yes	Yes	No	Existing
Thailand	Yes	No	Yes	Developing
Vietnam	No	No	Developing	No

With a few countries possessing specific crowdfunding regimes, some regulating it under preexisting laws for other types of finance and a few more not possessing any regulatory mechanism, the legal environment for EAP overall has not yet fully addressed crowdfunding. There is a need for crowdfunding-specific legal and regulatory regimes, both to address an innovative form of finance, and to allow for legal cohesion amongst EAP nations.

Future crowdfunding legislation should be concerned with both the creation of a safe market for investors and allowing crowdfunding platforms the prerequisite freedom to grow as institutions within the financial sector.

## INFORMATION SHARING

A critical issue for the future of crowdfunding as a source of finance is the context for information sharing. Credit information typically includes basic identification data (name, address, birthdate) as well as payment history. Having accurate credit data is essential for new forms of lending relationships which consist of far less personal contact between the investors and investees, as in the case with crowdfunding. In countries which rely on a public sector registry for credit data, access is typically restricted to regulated financial institutions which have mandatory reporting requirements. Crowdfunding platforms and other alternative finance ventures which are not considered regulated financial institutions do not have access to these data, which are usually housed in the Bank Superintendent or Central Bank. Private Credit Bureaus which could sell data to the crowdfunding sector are largely lacking in the region as only five of the most developed economies have Private Credit Bureaus that possess credit scores.

Without access to the highly predictive credit information, crowdfunding enterprises may be at a distinct disadvantage to traditional lending institutions, a situation which will limit healthy competition within EAP financial sectors. Some crowdfunding platforms in the region indicate that they are using nontraditional sources of data on investees such as from e-commerce sites and social media. However while innovative, these proxy data may still be less useful than investee credit histories in assessing risk. Unlike credit data, information obtained from e-commerce and social media may not accurately portray investees' performance under all circumstance, including economic downturns. Information sharing between credit institutions and crowdfunding platforms is a critical part of the financial infrastructure that this new industry will need to access and develop to reduce risk and expand their customer base.

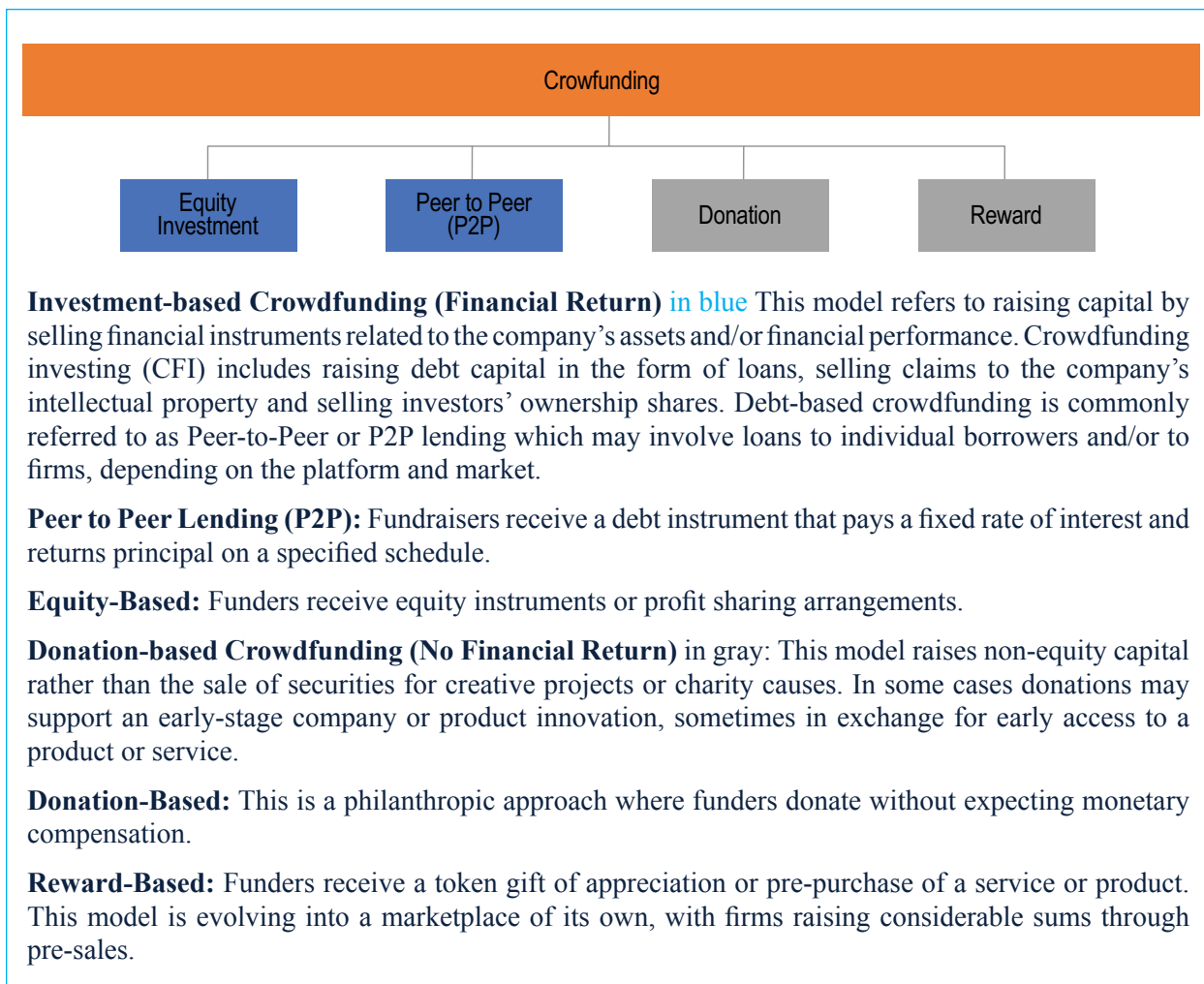


## LOOKING FORWARD

Crowdfunding is causing, and will continue to cause, disruption amongst the financial sectors of EAP countries. Crowdfunding heralds significant opportunities to increase financial inclusion, market diversity and continued economic growth for the region. In order to best facilitate positive outcomes from this financial disruption, action by EAP governments should be anchored around several main policy pillars:

1. Draft specific legislation that applies to equity based crowdfunding and P2P lending;
2. Facilitate credit information sharing amongst a broader range of institutions; and
3. Encourage consumer education with regards to alternative finance.

Looking forward, technology is unlikely to be the limiting factor for expansion of crowdfunding in East Asia. Instead, other “analog” development issues such as the adequacy of the legal and regulatory framework, agreements for sharing credit data across financial institutions of various types and even more fundamental aspects of economic development around the rule of law as related to commerce and finance such as minority shareholder protections and bankruptcy regimes are more likely to be the key obstacles. Without progress on these issues growth of this promising new technology enabled business model will be slower and more risky than otherwise, presenting critical missed opportunities for the region’s small businesses.



Source: Infodev 2013



# SME FINANCE COUNTRY CASE STUDIES



The World Bank Group promotes small and medium-sized enterprise (SME) growth through both systemic and targeted interventions across the globe. In total, World Bank Group support to SMEs has been estimated at approximately \$3 billion a year, taking into account commitments, expenditures and gross exposure. Targeting SMEs is not an end in itself, but a means of creating economies that employ more people and create more opportunity for citizens to achieve prosperity.

While access to finance is identified as a top challenge for SMEs across countries and contexts, developing effective policies and interventions for financing SMEs remains challenging, due to the enormous number of SMEs and the magnitude of their demand for finance. Reflecting on successes and challenges from interventions across country contexts is therefore critical to contributing to the collective knowledge on how to best help SMEs access finance.

The Country Case Studies that follow in this section examine interventions and studies targeted at improving access to finance for SMEs in a range of countries: Kenya, Ethiopia, India, and China. While the context and structure of these four economies are vastly different, some common threads underlie the set of issues facing SMEs in accessing finance in all four countries.

One common thread across countries is the rapid evolution of the SME market, and the persistent financing gap (estimated at over \$1 trillion for formal MSMEs and as much as \$2.6 trillion for formal and informal MSMEs). The absolute number of SMEs across the globe is growing, and in many countries financial institutions are increasing their share of lending to SMEs in dramatic proportions.

Still, according to global benchmarks and measures such as the World Bank's Enterprise Surveys, demand for finance from SMEs outstrips supply, and large financing gaps persist. In the absence of fully developed financial sector infrastructure such as credit information sharing, collateral registries, efficient electronic payment systems and enabling regulation, financial institutions face structural risks and barriers to meeting the surging demand, and must think and act creatively to meet the needs of SMEs.

The diversity of SMEs is another common thread across countries. In most countries, there is no unified definition of SMEs by governments or by banks, and banks use widely differing interpretations of what they consider SMEs. What is called 'SME finance' actually consists of a wide variety of lenders, with very different target markets. Micro-oriented financial institutions offer scaled up versions of microfinance products, including working capital loans and overdrafts to the smallest enterprises, often utilizing relationship-based lending. Corporate-oriented financial institutions on the other hand target medium enterprises and offer more complex and diversified products, often using credit scoring technologies in appraisal. Considering the enormous diversity of SMEs in each country case, a common thread is that a 'one-size-fits-all' approach cannot be applied to financial institutions' involvement in this fast-growing market.

In addition to the diversity of SMEs within countries and the lack of a clear universally used definition in most countries, another common thread is the exclusion and marginalization of specific sub-groups of SMEs. Women entrepreneurs in particular face unique and pressing challenges that require targeted and tailored approaches. One-third of the

world's SMEs in the formal sector are currently run by women. While finance is a challenge for male and female enterprises alike, the difficulties are amplified for women, who are less likely to own assets which can serve as collateral and are more likely to suffer exclusion based on unequal property rights or discriminatory regulations, laws and customs. As women-owned enterprises borrow and grow, they tend to employ greater numbers of women than their male-owned counterparts, suggesting that targeting SME finance for women entrepreneurs holds the potential for major economic and development gains and enhanced inclusion.

The SME Finance Quick Lessons that follow provide some important insights into the ways in which governments and financial institutions can keep pace with the strong demand for finance from SMEs. The Quick Lessons highlight concrete models for serving specific segments of SMEs, such as innovative start-ups and women entrepreneurs, which have the potential for replication in other contexts.

- In Kenya, the Quick Lesson on Bank Financing of SMEs summarizes a joint study between the World Bank and the Central Bank of Kenya to explore the supply-side of SME finance and its recent evolution. The Quick Lesson discusses the rapid growth in lending to SMEs by Kenyan banks, and provides a clear set of policy recommendations for the Kenyan government to support the growth of the SME finance market in Kenya.

- In Ethiopia, the Quick Lesson on financing women entrepreneurs profiles a successful and effective model for targeting women entrepreneurs that was demonstrated through a World Bank-funded program, the Women's Entrepreneurship Development Program (WEDP). Through a combination of liquidity and technical assistance to financial institutions, WEDP was able to incentivize Ethiopia's largest lenders to actively target women-owned SMEs, and has transformed the landscape for serving women-owned enterprises in the country.
- In India, the Quick Lesson on Early Stage Financing and Franchisees highlights the early gains of the India SME Growth, Innovation, and Inclusion Project, the World Bank's first loan to support the development of startup debt and introduce franchise finance. By leveraging the growing role of franchisors in India, the project demonstrates a model for increasing access to finance for franchisees in the service sector.
- In China, the Quick Lesson looks at SME finance in the context of China's economic slowdown. The Quick Lesson reviews a report on China's SME Finance Market in 2014-2015, and highlights how the 'cold wave' in China has led to declining prosperity of SMEs, and a declining growth rate of lending to SMEs. The Quick Lesson provides important insight into how China can actively support the SME sector to weather ongoing economic conditions.

# Financing Women Entrepreneurs in Ethiopia

- Francesco Strobbe and Salman Alibhai<sup>24</sup> -



## BACKGROUND

The challenges faced by women-owned enterprises in the developing world are substantial. Only one-third of the world's SMEs in the formal sector are currently run by women, and women-owned businesses typically underperform men's.

Across countries and contexts, access to finance is continuously identified as the leading constraint faced by women entrepreneurs. While finance is a challenge for male and female enterprises alike, the difficulties are amplified for women, who are less likely to own assets which can serve as collateral and are more likely to suffer exclusion based on unequal property rights or discriminatory regulations, laws and customs. An estimated 70% of women-owned SMEs in the formal sector in developing countries are unserved or underserved by financial institutions. This amounts to a financing gap of \$285 billion. A diverse range of economic research shows that addressing this financing gap and investing in women-owned enterprises is one of the highest-return opportunities available in emerging markets. As they grow, women-owned enterprises enhance labor participation and boost broad-based economic growth. In particular, due to higher female unemployment rates and the fact that women are more likely to hire other women, the growth of female-owned enterprises can be a key driver in reducing high overall unemployment rates.

## WOMEN ENTREPRENEURS IN ETHIOPIA

Over the past decade, Ethiopia has achieved high economic growth, averaging 10.7 percent per year, establishing the country among the fastest growing economies both in Africa and the developing world.

However, Ethiopia is falling behind its peers in the area of credit to the private sector. According to the World Bank's Enterprise Surveys access to finance is perceived as the main business environment constraint by micro (41%), small (36%), and medium (29%) enterprises in Ethiopia, compared to a Sub-Saharan Africa average of 24%, 20%, and 16% respectively.



A female entrepreneur electrician in Addis Ababa who participated in entrepreneurship training offered through the Women's Entrepreneurship Development Program (WEDP). She used to be in communications but switched professions after discovering that electricians earn more money.

At the same time, opportunities for women entrepreneurs in Ethiopia lag far behind those of men. In The Economist's Women's Economic Opportunity index, Ethiopia occupies the 107th rank out of 112 countries. Most growth-oriented women entrepreneurs fall into a 'missing middle' trap, in which they are served neither by commercial banks nor by microfinance institutions. High minimum loan sizes and excessive collateral requirements restrict women's access to loans from commercial banks. Microfinance Institutions (MFIs) primarily cater to micro-firms with group lending schemes that provide very small loans, and tend to have

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low outreach to women (30%). Growth-oriented women-owned enterprises are therefore starved of the investment they need to thrive.

## WOMEN'S ENTREPRENEURSHIP DEVELOPMENT PROJECT

WEDP is a \$50 million IDA investment lending operation designed to address the key constraints for growth-oriented women entrepreneurs in Ethiopia. The Governments of Canada and the United Kingdom are key development partners funding part of the project's activities with an additional \$13 million. The project began in October 2012.

WEDP's objective is to increase earnings and employment for women-owned enterprises in Ethiopia. It created the first ever women-entrepreneur focused line of credit in Ethiopia in 2013, and the demand has been staggering. The WEDP line of credit is disbursing roughly \$2 million USD in loans to growth-oriented women entrepreneurs every month, far exceeding initial targets. In tandem, several hundred women participate in the project's cutting-edge entrepreneurship training program each month, which draws lesson from modern cognitive psychology and equips participants not only with business skills in the traditional sense, but also with the ability to 'think like an entrepreneur'.

As of June 2016, the project has provided loans to over 4,000 women entrepreneurs and entrepreneurship training to over 7,500. The project has exceeded most of its own forecasted plans and expectations, and is amongst the fastest-disbursing and highest-rated projects in the region. The project

was awarded a Vice Presidential Unit Award in 2015 and an Innovation Award in 2016, based on its achievements in rapidly and creatively responding to the needs of women entrepreneurs in Ethiopia.

## HOW IT WORKS

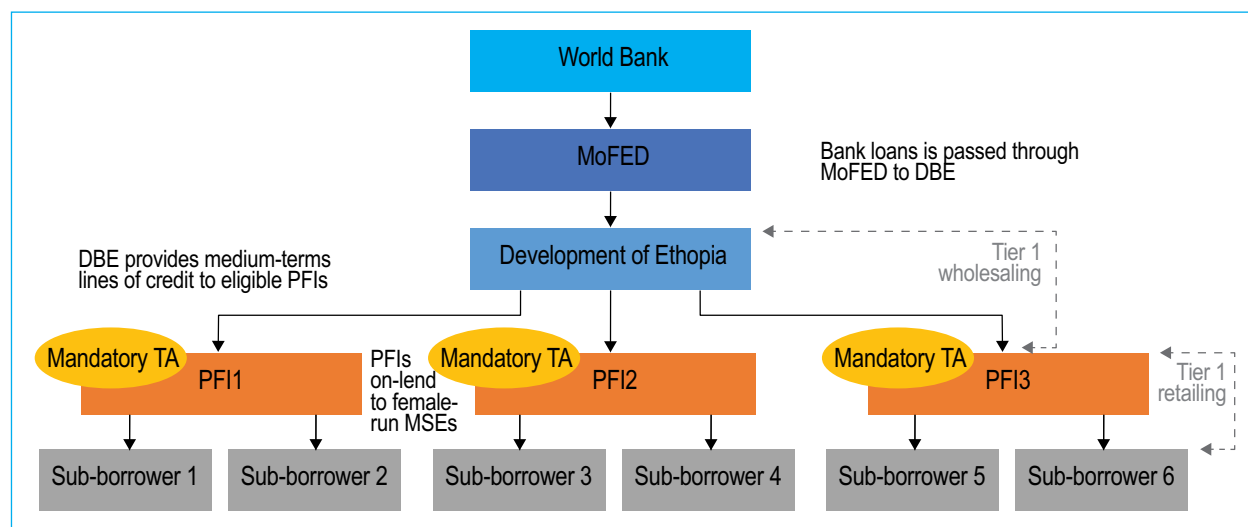
WEDP's line of credit involves a market "up-scaling" operation where the Development Bank of Ethiopia (DBE) acts as a wholesaler and microfinance institutions act as retailers. The project uses an incentive approach aimed at (i) helping DBE develop a new business line involving wholesaling of SME subsidiary loans and provision of related technical support to participating MFIs; and (ii) helping the MFIs build up a high quality SME loan portfolio based on credit techniques that have been developed and validated under successful micro and small loan programs in other countries, introduced through downscaling or upscaling approaches to microfinance.

The figure below illustrates the actual flow of funds and organizational arrangements under WEDP:

## TOP ACHIEVEMENTS

WEDP is changing the way the microfinance sector caters for micro and small entrepreneurs and is reaching previously underserved segments of the population. WEDP disbursed \$42 Million USD in loans to female entrepreneurs as of June 2016, against a target of \$30 Million USD, with very healthy repayment rates (99.6%).

An embedded impact evaluation component, designed through a partnership between the

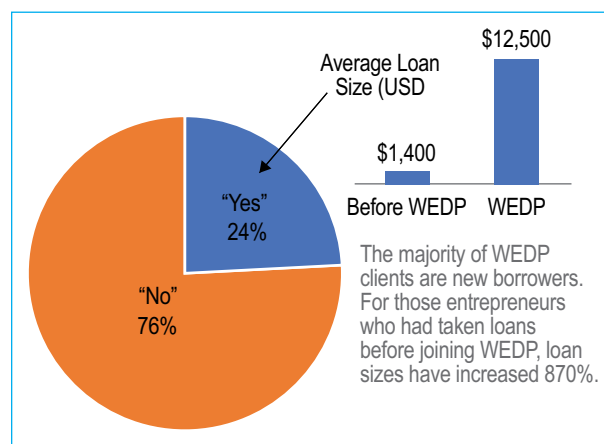


Finance & Markets Global Practice and the Gender Innovation Lab, is capturing key learnings and results of the project.

Some key achievements are as follows:

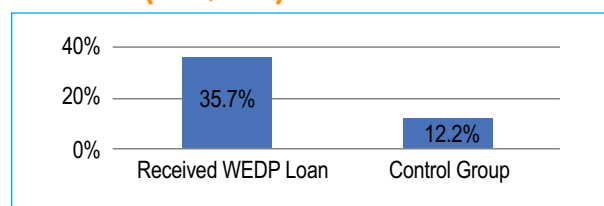
- 1. Reaching the underserved.** WEDP is successfully reaching its target segment of underserved women entrepreneurs, who have the desire and potential to grow their businesses. 76% of WEDP clients have never taken a loan before.
- 2. Unlocking needed capital.** One of WEDP's objectives was to increase loan sizes, since most Ethiopian women-owned enterprises were stuck in a 'missing middle' trap where loans offered by microfinance were too small to meet their needs. For repeat borrowers, loan sizes have increased on average by 870%.

### Borrowing History of WEDP Clients: "Have You Ever Taken a Loan?" (n=1,567)



- 3. Catalyzing growth.** According to initial surveys, enterprises that borrowed WEDP loans experienced an increase of 24% in annual profits and 17% in net employment for Ethiopian women entrepreneurs, one year after taking the loan. These female-owned businesses are continuing to grow, as the impacts of capital investments play out. Repayment of loans stand at 99.6%.

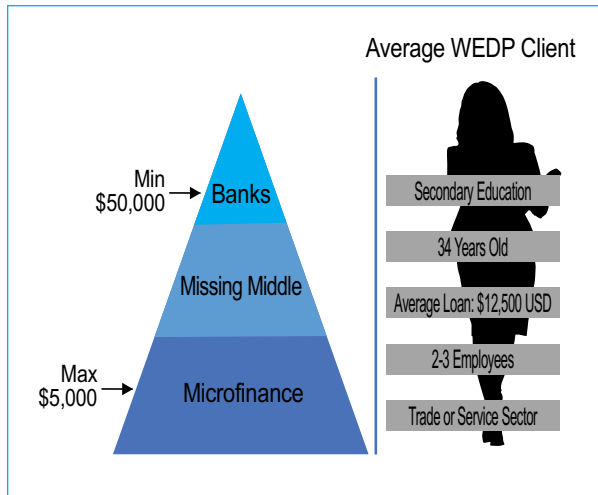
### Percent Change in Yearly Profits in Year 1 of WEDP (n=2,369)



- 4. Improving capacity of lenders.** Through a dedicated technical assistance component, WEDP is building the capacity of Ethiopia's leading microfinance institutions (MFIs) to deliver loans to women entrepreneurs. The MFI's improved ability to appraise, resulted in their capacity to reduce the collateral requirements from an average of 200% of the value of the loan to 125%. At the same time, WEDP microfinance institutions are adopting and diffusing new techniques to reach and serve women entrepreneurs better. They are developing new loan products and recognizing new forms of collateral such as vehicles, personal guarantees, and even business inventory, to secure loans.

"With WEDP, the microfinance institutions' appetite for risk has increased. Previously, they provided loans in small amounts of \$1000 - \$1500. Now, they are making WEDP loans averaging over \$10,000. Plus, they have taken part in a capacity building program, which helped them assess these larger loans using cash flow analysis and risk mitigation techniques. So the MFIs are strengthening both in terms of loans disbursed as well as in their knowledge of lending" (Beimnet Foto, Principal Appraisal Officer, Development Bank of Ethiopia)

- 5. Underwriting innovations in the sector.** Through partnership between the World Bank's Finance & Markets Global Practice and the Gender Innovation Lab, WEDP is introducing innovative credit technologies to lenders, such as psychometric tests which can predict the ability of a borrower to repay a loan and reduce the need for collateral. This technology allows entrepreneurs who do not have collateral to take an interactive test on a tablet computer which predicts their likelihood to repay. If they score highly, they can borrow without traditional collateral. The test is being piloted under WEDP and subjected to a rigorous impact evaluation. Other banks are asking for the technology already, and scaling-up this technology could have a sea-level change on access to credit in Ethiopia



## TOP CHALLENGES

Unlocking the growth potential of Ethiopia’s women entrepreneurs involves addressing a number of intractable constraints. To date, the project has encountered several important challenges and learnings:

- 1. Lenders need help too.** Helping lenders move away from traditional collateral-based lending and adopt innovative (and likely more effective) forms of appraisal is a powerful way of expanding access to women entrepreneurs. Improved appraisal can be easier and more profitable for lenders, but changing the way a bank makes loans takes time, and most lenders are cautious when reforming these fundamentals. Flexible, responsive, long-term technical assistance to lenders is critical in bringing about sustainable changes.

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“WEDP’s Access to Microfinance component provides excellent experience to show financial institutions that women entrepreneurs can be good borrowers and that with good cash flow analysis and lending procedures, collateral requirements can be relaxed” (Independent Review of WEDP, July 2015).

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- 2. Engaging men is critical.** When women entrepreneurs grow their businesses, dynamics in the household and the family can change. Engaging husbands, partners, and male family members to ensure their buy-in and support is critical. Linking women entrepreneurs with trusted male mentors and role models in other sectors can help them transition into more profitable businesses.
- 3. Training is hard.** While most women entrepreneurs say that they want to enhance their skills, many don’t register for training programs. Women usually cite time constraints or concerns about quality as the main reasons why they won’t attend entrepreneurship trainings. At the same time, women who participate in WEDP’s entrepreneurship trainings tend to rate them very highly and recommend them to others. Entrepreneurship training needs to be of high quality, in accessible locations, and at convenient hours, in order to attract busy women entrepreneurs. Marketing the benefits of training programs is critical.



A female entrepreneur who owns an animal husbandry business in Addis. She borrowed a WEDP loan to expand the shed for her animals.

# Bank Financing of SMEs in Kenya

- Gunhild Berg and Michael Fuchs<sup>25</sup> -



## INTRODUCTION

The financial sector in Kenya has expanded rapidly over the last decade and business financing has played an important role in the growth strategies of financial institutions. As the Kenyan economy is predicted to enjoy a period of relatively high growth, the financial sector's role to channel credit affordably and efficiently to SMEs will be central for inclusive and sustained economic development.

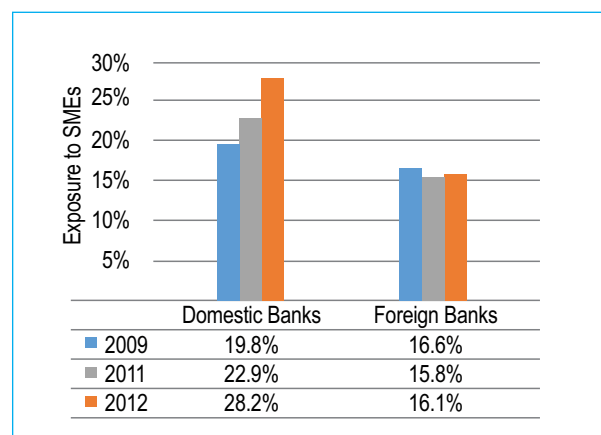
Despite growing interest in the SME segment, Kenya still lacks rigorous analysis on the size and evolution of the SME finance market. There is no systematic market-wide analysis of the trends and recent developments in SME finance, the drivers and obstacles to further engagement in the segment and its future prospects. The problem exists on both the demand-side and supply-side of SME finance.

A World Bank and FSD Kenya team therefore embarked on a joint study with the Central Bank of Kenya to explore the supply-side of SME finance and its evolution between 2009 and 2013. A study of the demand side is currently ongoing. In addition to quantifying the extent of banks' involvement with SMEs and the related growth rate, it shows the exposure of different types of banks in the segment, the portfolio of services most used by SMEs and the quality of assets. The report also discusses the regulatory framework for SME finance, as well as the drivers and obstacles of banks' involvement with SMEs and their specific business models.

## STRONG GROWTH IN SME FINANCING

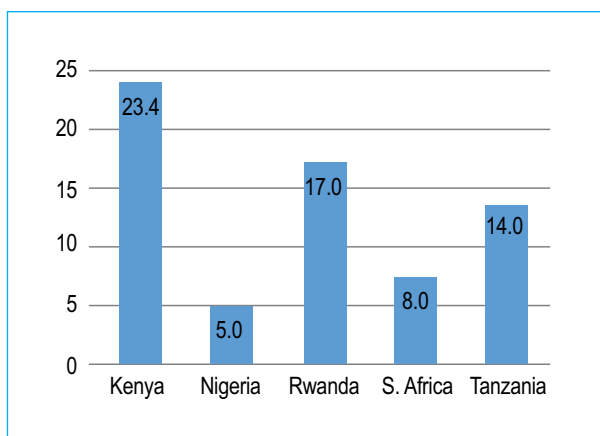
The involvement of Kenyan banks in the SME segment has grown remarkably between 2009 and

2013. The total SME lending portfolio in December 2013 was estimated at KSh332 billion, representing 23.4 percent of the banks' total loan portfolio. The SME portfolio grew fast in absolute value but also as a percentage of total lending: in 2009 and 2011 the total SME portfolio was estimated to be KSh133 billion and KSh225 billion, respectively, and SME lending represented 19.5 percent and 20.9 percent of total lending, respectively. These figures show that in the context of general growth of the financial sector, SME financing represents a growing share of the commercial banks' lending portfolios. Growth in the SME portfolio is increasingly being driven by domestic banks while the share of foreign banks declined between 2009 and 2013.



The share of SME lending relative to total lending by commercial banks is higher in Kenya compared to other major markets in Sub Saharan Africa such as Nigeria and South Africa, where SME loans accounted for five and eight per cent of total loan portfolios in the respective survey years. The ratio is

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somewhat higher in Rwanda and Tanzania; however these are smaller markets with a relatively limited presence of large-scale firms.

### UNIQUE DEFINITION OF SMEs REMAINS CHALLENGING

There is substantial diversity in the way banks approach the SME segment, both in the way they define SMEs and in terms of the banks' business models. Although the Kenyan government proposed adopting a unified definition of the SME segment in terms of turnover and number of employees, the banks still use definitions that differ significantly both in terms of the information that is being collected and the categorization of SMEs which is not surprising given the difficulty to collect such information. Within each category, the banks' interest in engaging in the SME sector is quite varied: there are both leaders devoted to innovation in SME financing and other banks for which SMEs are not a target client group. This illustrates the dynamism of the Kenyan market in that a 'one-size-fits-all' approach cannot be applied to the banks' involvement in this fast-evolving market.

### DIFFERENT BUSINESS MODELS

Banks' strategies in the SME segment vary depending on their business model. The report identified three main types of business model (see table on page 56): the corporate oriented business model (CBM), the supply-chain oriented business model (SBM), and the microenterprise-oriented business model (MBM). Although there is overlap between these categories, banks tend to differ in terms of lending technologies, customer acquisition

strategies and risk management mechanisms. MBMs are large, home-grown institutions with a historical involvement in the microfinance space. They tend to have extensive outreach networks due to their move from the mass retail/microfinance market into the SME space, and they have a large network of bank branches equipped with loan officers who are in a position to assess SME loans. Additionally, these institutions have embraced alternative outreach models such as agency banking and mobile banking as a means of creating points of contact with hard-to-reach communities and as service delivery channels. SBMs instead tend to be mid-sized institutions that originally targeted specific clienteles or business communities in the Kenyan economy and have now expanded to reach a wider customer base. These banks typically use a combination of specialized supply-chain finance products, such as invoice discounting and local purchase order financing and specialised asset finance products, such as hire purchase. Finally, CBMs tend to be foreign-owned multinational banks focusing on the higher end of the SME market. Their institutional structures allow them to draw upon sophisticated credit-scoring tools, but limit their ability to innovate due to long chains of command, often headquartered abroad.

### CHALLENGES REMAIN

Despite the positive developments over the last few years, the cost of credit for SMEs remains high and there is still considerable room for product innovation in the SME finance space. The large majority of SME loans are overdrafts. While overdrafts can be useful in financing working capital when businesses need fast access to liquidity, they expose SMEs to interest rate and liquidity risks, particularly if overdrafts are used to finance longer term investments. Agricultural SME lending remains very limited as well, representing a small percentage of the total portfolio, even though the sector is the backbone of the Kenyan economy.

The high cost of credit is attributable to a number of factors including the limited use of positive information sharing about borrowers in the market, inefficiencies in the collateral registration process, the cost of the judicial process and high overhead costs. The recent move towards positive information sharing by banks should go some way towards addressing these problems, but positive information



sharing from all credit providers (including microfinance institutions for example) would add important value to the information already present in the credit bureaus and should be prioritized going forward, provided that data quality can be ensured.

In addition, the collateral registry could be made more efficient in terms of the speed and the range of items accepted as collateral. Resolving the legal and regulatory challenges, especially regarding the contractual environment, will require significant reforms over a period of several years. Supporting the alternative dispute resolution system established by the Kenya Bankers Association and the Association of Kenya Credit Providers would be a promising approach. Such a system would ensure that the majority of disputes are mediated and resolved prior to entering the judicial system, therefore avoiding lengthy judicial procedures.

## SPACE FOR INNOVATION

Innovation in the SME financing space could also be driven by the development of factoring and financial leasing. It is to be anticipated that the introduction of such products would lower transaction as well as borrowing costs for SMEs and reduce reliance on collateral by drawing on more diverse sources of security. The main constraint to financial leasing appears to be the ambiguous treatment of leasing in the Hire Purchase Act and Income Tax Act as well as the application of VAT. Potential constraints to the development of factoring, such as the recourse

mechanism and the impact of stamp duties, need to be explored with a view to enabling a local market for factoring. In addition, it would be useful to study in more detail the potential and feasibility of implementing an electronic reverse factoring scheme similar to the one operated by Nafin in Mexico or a factoring scheme as used in Paraguay or Peru. Such shared platforms could lower transaction and borrowing costs further and introduce more competition into this market segment while also increasing transparency.

## RECOMMENDATIONS

The report offers a number of recommendations that could support the growth of the SME finance market in Kenya. Among those are:

- Harmonizing the definition of SMEs to facilitate the analysis of the development of SME finance over time;
- Increasing the scope of credit information sharing;
- Creating a more conducive environment for factoring and leasing; and
- Improving the enabling environment for SMEs by introducing digitized movable and immovable collateral registries and improving rules and procedures to create, recognise and enforce security over movable assets as well as introducing Alternative Dispute Resolution or other out-of-court enforcement mechanisms.



	<b>Corporate Oriented</b>	<b>Supply-chain Oriented</b>	<b>Micro-oriented</b>
Banks	Barclays, CFC Stanbic, Standard Chartered	BoA, Chase, DTB, Ecobank, FINA, I&M, NIC	Co-op, Equity, Family, KCB, KREP, Jamii Bora
<b>Target market and risk management</b>			
Depth of target market	Medium enterprises	Small and medium enterprises	Micro, small and medium enterprises
Information used in credit appraisal	Hard information on business	Combination of hard and soft information on the business and entrepreneur, and information on government and corporate clients in supply chain of SME	Soft information on the entrepreneur and the business
Lending technology	Credit scoring technology used for transactions based lending	Secured credit using invoices and hire-purchase as collateral	Relationship-based lending
<b>Products and services offered</b>			
Typology	Scaled down version of products offered to corporates	Specialised SME financing products	Scaled up versions of retail or microfinance products
Examples	Asset finance, working capital finance, FX, wealth management	Invoice discounting, hire purchase, leasing, overdrafts	Working capital loans, overdrafts, asset finance, FX
<b>Approach to customer acquisition</b>			
Approach to customer Acquisition	Brand recognition	Networks of corporate customers	Large outreach networks encourage graduation from micro to the SME space
<b>Key characteristics</b>			
Type of bank	Large multinationals	Small and mid-sized banks of local and sometimes regional origin	Large and medium-sized local banks
Outreach networks	Minimal	Minimal	Extensive

# Innovative Early Stage Financing for SMEs in India

- Mihasonirina Andrianaivo and Rosanna Chan<sup>26</sup> -



## BACKGROUND

In India, Micro Small and Medium Enterprises (MSMEs) account for more than 80 percent of total industrial enterprises, produce over 8000 value-added products and employ an estimated 60 million people. MSMEs in India contribute around 45 percent to manufacturing output and about 40 percent to exports, both directly and indirectly. In addition, over 50 percent of MSMEs are rural enterprises and widely distributed across low-income states making them an important sector for promoting inclusive economic growth and poverty reduction. With one million people entering the labor force every month in India, MSMEs have the potential to be an important source of wage employment and entrepreneurship. They can also foster innovation as well as be the cradle for the Government's 'Make in India' vision, which encourages companies to manufacture their products in India. For these ideas to take shape, addressing the key constraints that inhibit MSMEs from accessing finance is of utmost importance.

A lack of adequate finance is one of the biggest challenges facing the MSME sector. Financial constraints hamper growth, competitiveness, response to shocks, as well as employment and investment decisions at the firm level, thus affecting the performance of the economy at large.<sup>27</sup> Financial institutions have limited their exposure to the sector due to a higher risk perception, information asymmetry, high transaction costs and lack of collateral. The MSME census of 2006-07 estimated that about 87 percent of MSMEs did not have any access to finance and were self-financed. Credit towards micro and small enterprises represents only

around 13-15 percent of the portfolios of formal financial institutions.

Hence, a focus on spurring key areas within the MSME sector is critical for growth and employment. First, accelerating entrepreneurship finance is crucial for generating large-scale employment, but also providing solutions to a myriad of problems by supporting innovative solutions in sectors such as education, health, climate change, information technology (IT) and financial inclusion. Second, supporting the services sector which accounts for 67 percent of GDP and encompasses 71 percent of MSMEs provides an impetus to growth and exports. Sectors such as education, health, entertainment, financial services, are the fastest growing sectors in the India economy, and are not only the drivers of economic growth, but also have the potential to significantly contribute to employment for future generations as India's economic composition continues to shift. Service sector growth has also propelled growth in several low income states and has therefore contributed to promoting inclusive growth in the country. Third, supporting manufacturing growth is critical given that 75 percent of the MSMEs total output comes from the top 10 industries in manufacturing. The manufacturing sector is a priority for the Government of India (GoI) which is targeting to increase the share of the manufacturing sector to 25 percent by 2022 from the current 16 percent. Further, enhanced provision of finance to India's manufacturing sector can contribute to maximizing the growing opportunities from increasing labor costs in China and help realize the opportunities arising from GoI's recent "Make in India" initiative.

<sup>26</sup> Mihasonirina Andrianaivo is Financial Sector Specialist in the Finance and Markets Global Practice and Rosanna Chan is Economist in the Transport and ICT Global Practice of the World Bank Group.

<sup>27</sup> Chan, Rosanna. 2014. Financial constraints, working capital and the dynamic behavior of the firm. Policy Research working paper; no. WPS 6797. Washington, DC: World Bank Group.

## INDIA MSME GROWTH, INNOVATION AND INCLUSION PROJECT

The project is a \$550 million IBRD investment operation designed to address the key constraints for MSMEs in India. It supports innovative financial products, frameworks and tools for MSME financing. It is the World Bank's first loan to support the development of startup debt, and introduces franchising finance to the India context.

The project provides a credit line of US \$500 million through the Small Industries Development Bank of India (SIDBI, the apex development bank for MSMEs), and provides supports to SIDBI's efforts in direct and indirect financing, leveraging SIDBI's role as a "market making" institution to boost private sector financing through demonstration effects.

In addition, the project is accompanied by a technical assistance component working with the Financial Sector Reform and Strengthening Initiative (FIRST) which is an active partner supporting an additional \$1.7 million to help enhance institutional capacity, product innovation and development, and outreach and dissemination.

The project was approved in February 2015 and became effective in June 2015. As of November 2015, it has disbursed US \$100 million in refinancing and is the largest disbursing project in the India portfolio.

## EARLY STAGE MSMEs AND STARTUPS IN INDIA

India's startup ecosystem is currently one of the fastest growing in the world. Between 2011-2014, India's start-up ecosystem attracted 300 Venture Capital (VC)/Private Equity (PE) and 225 angel investment deals worth over US\$2.3 billion and over 20 mergers and acquisitions worth US\$1 billion. India has the potential to build about 2,500 highly scalable businesses that could generate revenues of US\$200 billion over the next 10 years (2014 estimates). To meet this potential, India needs to build a pipeline of over 10,000 startups. The Mitra report (2012) estimated that around US\$50 billion of capital was needed over the next decade to build the pipeline of startups and entrepreneurial activity needed for India to meet its potential. Half of the capital inflows needed are in the form of debt for working capital needs.

However, debt financing for early stage companies is virtually non-existent and MSMEs also lack mezzanine risk capital products. While India has seen substantive growth of venture capital (VC), the financial market to support the ecosystem has been undeveloped in debt options to startups. The lack of debt financing in the ecosystem has meant that firms grow slower and are less able to take advantage of economic opportunities, and are often forced to turn



to equity to finance working capital – which is both an expensive way of financing working capital and reduces entrepreneurial capacity. In addition to the shortfall in early stage debt finance, MSMEs across various stages of growth lack mezzanine capital – which if provided – could help strengthen balance sheets by providing longer term funding and leverage additional funding.

## HOW IT WORKS

The development and scaling up of financial debt products, appraisal frameworks and on-lending models can catalyze the startup debt market in India. The box below, ‘Growth Path of Startups & Corresponding Financing Stage’, demonstrates the segment where there is a need for intervention. The credit line supports scaling up of lending to startups (including non-collateralized loans), early stage enterprises that focus on innovation and/or technology businesses. The credit line also supports the crowding in of the private sector toward this segment through on-lending.

This area of lending is on the frontier of innovative financial development. It leverages the extensive network of angel investors and other equity investors operating in this segment, to help signal credit worthiness and to foster and expand lending to bridge the gap toward Series A venture capital financing.

SIDBI has identified three key potential areas where innovating their existing approach can allow them to reach their objective to scale up their pilot portfolio. First, to develop faster appraisal

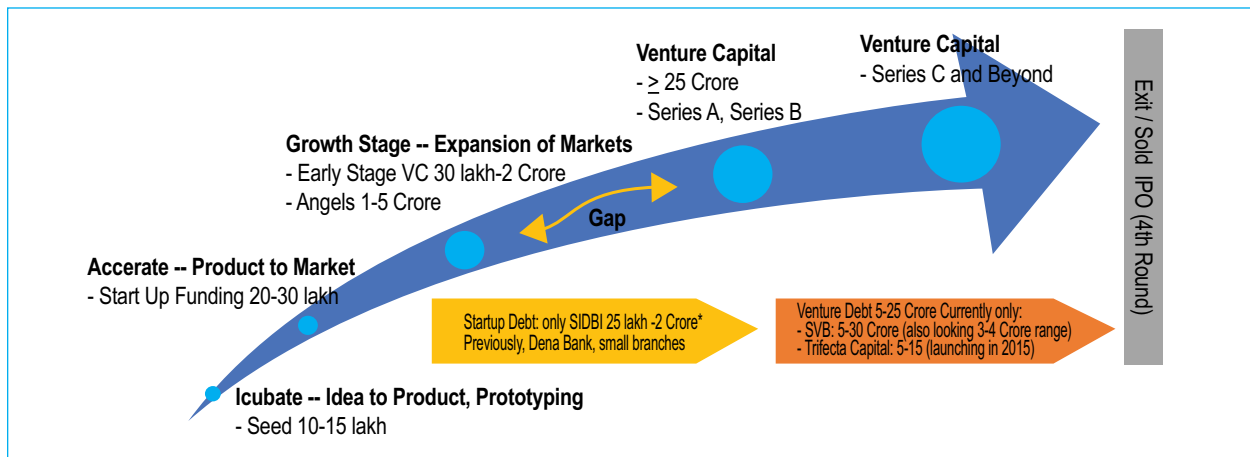
models that leverage industry assessments to reduce risk so as to process more loans in a shorter time. Second, to actively seek out partnerships and potential participating financial institutions (PFIs) interested in entering this segment and to develop incentive compatible models to on-lend. Third, to leverage digital technology by developing a financing electronic platform as a backbone to facilitate processing, sourcing and appraisal. The electronic platform provides not only a portal where startups, financiers and investors can connect, but also builds up credit and investing history over time - much like a combination of LinkedIn and Crunchbase.

## DEVELOPING FRANCHISEE FINANCING FRAMEWORKS

Financial institutions have thus far limited their exposure to the MSME sector -- particularly in the service sector which typically has softer collateral (e.g. fixtures, furnishings, equipment) and lack the immovable collateral used in traditional banking. The lack of franchising financing frameworks in India, despite the enormous opportunity for entrepreneurship and growth in the franchise market, is another example where traditional bank lending does not cater well to large and dynamic segments of the Indian economy.

The potential for growth in franchising is immense. The franchising industry is expected to quadruple between 2012 and 2017 contributing to almost four percent of India’s GDP (from an estimated

### Growth Path of Startup and Corresponding Financing Needs: India Context (2014)



\*Expected to adjust toward 3-4 Crore as firms grow.

1.4 percent of GDP as of 2012) and to create job opportunities for an additional 11 to 14 million people.

**Nonetheless, the lack of bank credit is constraining growth.** The financing ecosystem for franchising in India remains at a nascent stage. Most financial institutions in India have used traditional collateral/asset backed lending products to franchisee financing while franchisees (like other firms in the service sector) typically have softer collateral (including single purpose commercial buildings, leased lands etc.) coupled with smaller ticket size of loans.

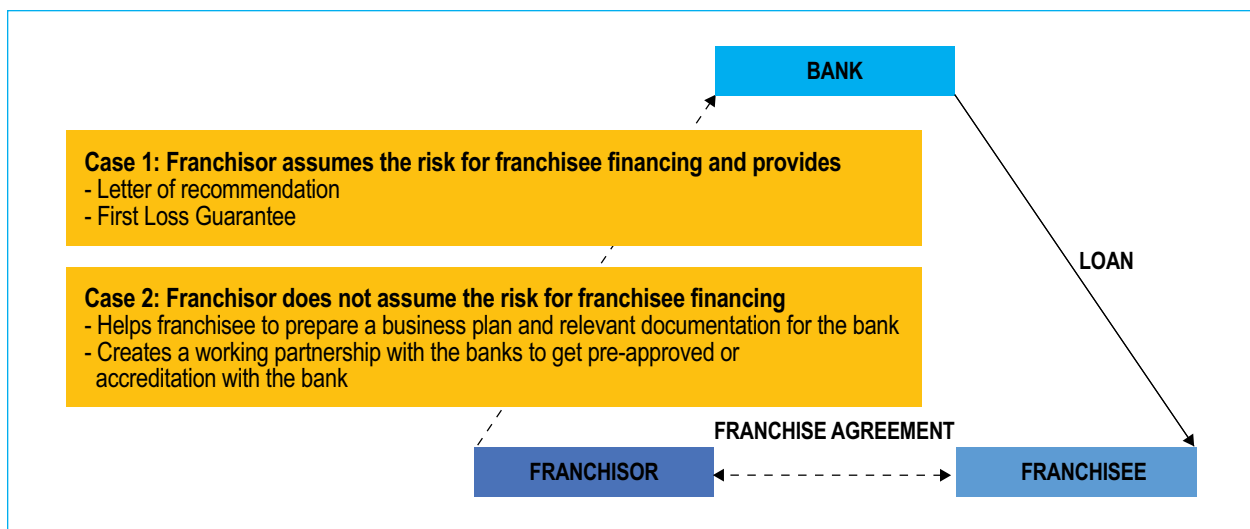
**The introduction of innovative financing mechanisms by financial institutions is needed.** Appropriate risk assessment frameworks to assess franchisees, with customized appraisal parameters that rely on business viability and cash flow assessment (rather than typical models that rely on collateral as a primary criterion for eligibility) are yet to be developed.

**To help address financing issues, one activity under the MSME project aims to support the development of innovative financial products to franchisees along the lines of channel financing structures, with adequate support from the franchising ecosystem, in particular from the franchisor.** One envisaged approach is to build on the relationship between the franchisor and the franchisee, to provide additional reassurance to the lending institutions. The financial institutions will actively engage the franchisor in assessing the franchisees

and mitigating credit risk. The franchisor could provide information, due-diligence of the business plan, credit screenings, ratings on franchisees, letters of recommendation, and first loss guarantees. The contours of such an arrangement could be designed along the lines of channel financing structures.

The challenge is the design of the partnership when the bank can be additionally deterred by the small ticket size of the loans and as opposed to channel financing, where the corporate provides a guarantee, the franchisor can be wary of providing a guarantee to the bank. Several avenues will be explored to design an appropriate product that will align all incentives. A strategy envisaged is to work at the “master franchisee” level because the latter has growth targets to meet and a clear incentive to expand the penetration of the brand. In that light, the master franchisee could be more willing to provide support to its sub-franchisees’ loan applications that ranges from information sharing, on past and ongoing performance, to financial comfort to lenders. This could for instance include first loss guarantees for selected sub-franchisees that the master franchisee would recommend. The partial guarantees could be funded by a “loss pool account” that has pooled aside part of royalties paid by all its sub franchisees.

Further, lenders may also find enough financial comfort in accessing detailed information on the franchisees, or in the franchisor’s strength (for instance whether the brand value has been sufficiently demonstrated in the country) as well as in the strength of its relationship with the franchisee.<sup>28</sup>



A risk assessment framework to be used by lenders would also be developed with the project's support.

Once the model scales up, the possibility of lowering financing costs/risk based on transactions and other firm data could also be considered.

**SIDBI is keen to develop such structures to finance franchisees and initial feedback from stakeholders has been strong.** The parallel technical assistance accompanying the project would support the design of such a product for SIDBI and other financial institutions, building on current and international best practices, but also on stakeholders' feedback provided during preparatory technical meetings.

**Improving the entire franchise financing ecosystem in India warrants supplementary actions.** These include for instance an enabling regulatory environment. An assessment of establishing a national franchise registry in India is another focus of the TA to improve the financing ecosystem. The registry will facilitate quicker loan processing by serving as a first level of due diligence for banks, offering consistent information on franchise agreements as well as underwriting information to enable them to assess whether or not to approve franchisee loans. It would serve as a national platform for online registration of franchisor/franchisee systems based on criteria such as adequate disclosures, standardized documents, etc. For potential franchisees, it offers a system

through which they can select a franchisor by looking at the approved franchise agreement.

**In addition to frameworks for franchisee financing, the MSME project also supports asset light models, cluster-centric financing, the potential use of supply chain data from e-commerce platforms and other innovative credit delivery arrangements.** The project tests multiple/alternative sources of information that can be used to address information asymmetry and mitigate credit risk in lending to MSMEs. It supports tailored credit appraisal and credit scoring methods to address the key constraints that inhibit finance not only for franchisees but also for other MSMEs in service and manufacturing sectors and start-up/early stage MSMEs.

## TOP ACHIEVEMENTS

- Introduced the World Bank's first engagement in supporting startup debt.
- Introduced structure franchising finance to India, which has the potential to create jobs for millions of people.
- Disbursement of US \$100 million 2 months after loan effectiveness.
- Project design is an example of a World Bank Group innovation into new product lines for country clients, leveraging and scaling up local innovations, and addressing the rapidly changing needs of a dynamic economy.



28 For example through a detailed analysis of the contract to understand the obligations of both the parties and to estimate the franchisee's abilities to fulfill its obligations under the franchise agreement.





# Financing SMEs Under the Cold Wave in China

- Jinchang Lai and Ming Li<sup>29</sup> -

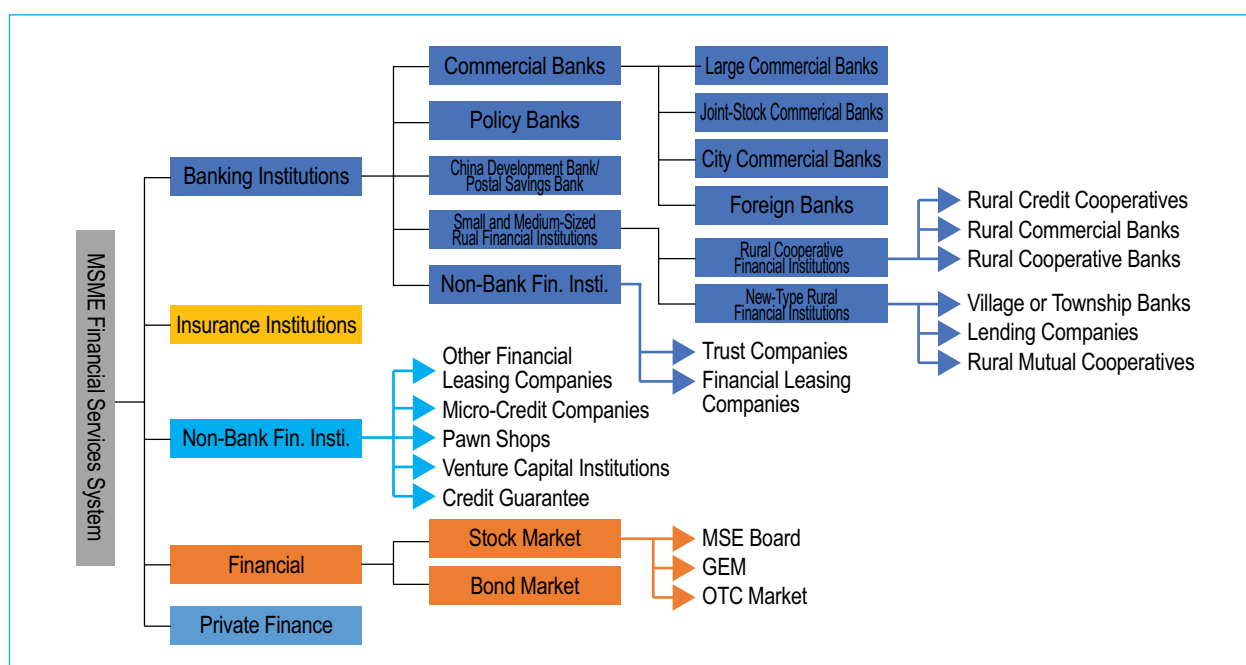


For most people engaged in MSME<sup>30</sup> finance in China, the term “New Normal” triggers mixed feelings. Given the current downward pressure being exerted on the economy, “New Normal” immediately brings to mind rising risk and intensive competition – and possibly slower growth. At the same time, it implies new opportunities brought by dynamic demand, deeper reform, infrastructural improvements and technological innovation.

The China MSME Finance Report 2015 is the 7th annual report on China’s MSME finance

development, produced by the Mintai Institute of Finance and Banking at the Central University of Finance and Economics. The report provides a comprehensive review on China’s MSME Finance market in 2014 and early 2015<sup>31</sup>. This note summarizes the key findings of the report, with a focus on the banking institutions regulated by the China Banking Regulatory Commission (CBRC) on the supply side (See Figure below for the major providers of MSME financial services).

## MSME Financial Service System



29 Jinchang Lai is Lead Financial Sector Specialist and Ming Li is Operations Analyst in the Finance and Markets Global Practice of the World Bank Group.

30 The Chinese report uses the term “micro and small enterprises -- MSE”, which corresponds roughly with the international understanding of MSME.

31 Unless otherwise stated, “MSME loans” in this note is interpreted broadly, including loans to micro, small and medium businesses, unincorporated but registered urban businesses as well as owners of such businesses.

## MACRO-ECONOMIC ENVIRONMENT IN 2014

Having to simultaneously deal with a slowdown in growth, make difficult structural adjustments and absorb the effects of previous stimulus policies, China's economy continued to face downward pressure in 2014. As a vulnerable part of the economy, MSMEs suffered from a shrinkage of demand and cost increases. China's SME Development Index shows that SMEs have been struggling below the prosperity level of 100 for 3 consecutive years. Many MSMEs have been wiped out by these events.

At the same time, over this period, the emergence of stronger entrepreneurship and innovation – particularly in technological fields and the IT-driven aspects of more traditional sectors – have brought great opportunities for MSMEs.

## OVERVIEW OF MSME FINANCE

Figure below provides a general picture of different sources of MSME financing at the end of 2014. The numbers in brown represent the financing scale to MSMEs. Among all the players, banking institutions (CBRC-regulated commercial banks, policy banks, small and medium rural financial institutions and other lenders) remained the largest financing suppliers for MSMEs. By the end of 2014, banking institutions were serving 11.45 million MSME borrowers, representing 20.44% of the total number of MSMEs in the country (56 million). In addition, other institutions including micro credit companies, pawn shops and financial leasing, although much smaller in scale, also provided more

MSME financing than they did in 2013. For the first time the stock market and venture capital market both contributed over RMB 100 billion of financing to MSMEs in 2014.

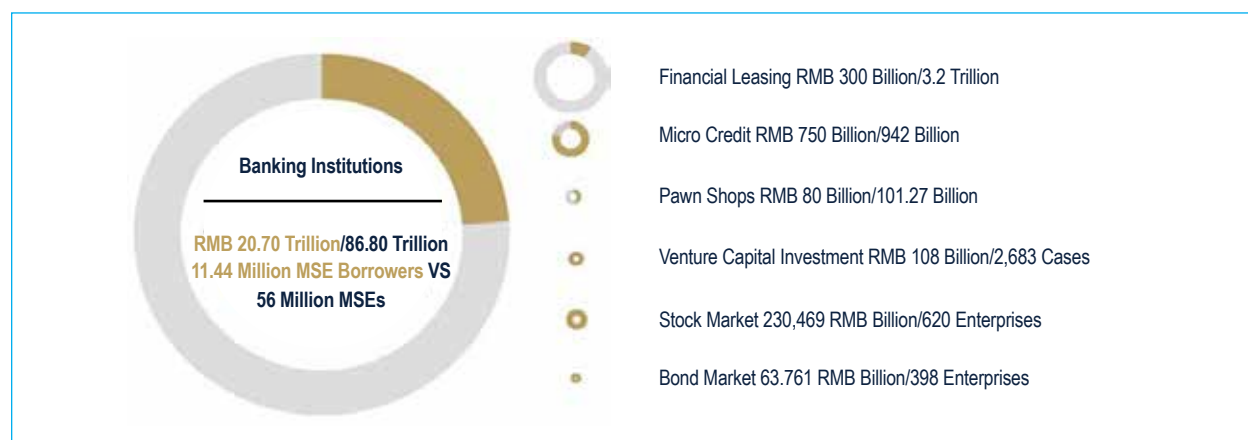
Despite the overall volume increase by the various suppliers, growth rates of MSME financing for most sectors decreased. The report suggests that the actual cost of debt financing for MSMEs did not drop as expected, regardless of the source of financing. To some extent, the technological and organizational changes undertaken by financial institutions (FIs) made MSME financing more efficient and cost effective, but the increased credit risk offset the cost savings and government incentives (including the People's Bank of China's (PBOC) reserve requirements and benchmark interest rates, as well as differentiated regulatory requirements from CBRC).

Similar to banking institutions, other MSME financing sources were also affected by the economic slowdown. When risks became more tangible and confidence started to decline, private finance was also badly affected. Hidden bubbles began growing with the aggressive expansion of the financial leasing sector. The stock market, meanwhile, required a series of reforms before it could be viewed as a reliable financing channel for MSMEs.

## CBRC-REGULATED BANKING INSTITUTIONS

In 2014, the traditional banking sector faced the 'New Normal' of high-risk, low-return, diversified competition and more stringent regulation. Competition heated up as a result of the liberalization

## MSME Financing in 2014



of interest rates, technological adaptation, entrance of private players as well as the rapid development of capital markets.

In 2014, the total outstanding MSME loans from CBRC regulated banking institutions was RMB 20.70 trillion<sup>32</sup> – an increase of 16.55% from the previous year. This represented 23.85% of total outstanding loans from banking institutions in the end of 2014 (RMB 86.80 trillion). The growth rate of the MSME portfolio was 4.2 percentage points higher than the growth rate of total outstanding loans for banking institutions. However the growth rate was lower than that of the previous year.

In terms of overall share, village and township banks (VTBs) showed the highest percentage of outstanding MSME lending in terms of their overall total lending portfolio (74.51%), and the big-5 ranked the lowest (15.01%).

On the other hand, in terms of outstanding MSME financing, the Big-5, the country’s five largest banks, accounted for RMB 4.45 trillion, ranking 1st among all banking institutions, followed by joint-stock commercial banks, city commercial banks and rural commercial banks. All groups contributed over RMB 3 trillion to MSME financing respectively (See Figure below).

### MAJOR COMMERCIAL BANKS UNDER CBRC REGULATION<sup>33</sup>

The increased risk of MSME lending was reflected by a notable increase in NPLs within commercial

banks. CBRC statistics indicate that by the end of December 2014, the total NPLs of all commercial banks was RMB 846.2 billion and the overall NPL ratio was 1.25%. This is in contrast to October 31, 2014, when the NPL for MSME lending was only RMB 445.2 billion and the NPL ratio was 2.25%, which was just one percentage point higher than the overall NPL ratio of the banking sector.

In response, most commercial banks took a defensive strategy and slowed down their rapidly expanding MSME lending. The growth rate of outstanding MSME loans at the end of 2014 was nearly four percentage points lower than that of 2013. Some major banks like ICBC and Minsheng Bank even encountered negative growth. As revealed by the Survey of MSME Bankers, the MSME credit approval rate had declined in nearly half of the commercial banks.

Besides the rising risk, commercial banks also faced the challenge of new competition when CBRC approved the establishment of the first batch of five private banks in the second half of 2014, followed by more in 2015. Three Internet tycoons, Baidu, Alibaba and Tencent all joined the market. With different backgrounds and business models, all of the private banks had clear strategies targeting MSMEs and private businesses. The rapid growth of internet finance also posed serious a challenge to traditional commercial banks.

While being increasingly prudent, **commercial banks took proactive measures to ensure business**

**Figure 3: Outstanding MSME Loans from Various Banking Institutions**



Note: Value in RMB 100 millions

<sup>32</sup> As of January 27, 2016, the USD: RMB exchange rate was around 1: 6.57.

<sup>33</sup> Commercial Banks in this section refers to large commercial banks, joint-stock commercial banks, city commercial banks and foreign banks only.

### **development while keeping risks under control.**

Apart from an active collection of NPLs and close monitoring of outstanding portfolio, commercial banks made greater efforts to explore new markets, develop new business models, make organizational changes and adopt new technology.

As MSME finance is increasingly viewed as part of retail business, some banks set up dedicated MSME finance units at HQ level, and some banks initiated a shift toward transactional banking in response to client needs. For example, China Merchant Bank already had a clear roadmap to transactional banking, focusing on organizational reform at the branch level.

To differentiate themselves and gain a standing place among the competition, commercial banks made innovations mainly in three areas: (1) efficient risk management through data mining using internet technology; (2) diversified service channels using mobile platforms and social applications (such as Wechat) to deliver comprehensive products and services; and (3) product innovation.

Looking ahead, balancing business development and risk control will remain the priority for commercial banks. The growth rate of MSME lending is expected to continue to fall. CBRC regulations will put weight on client numbers and internet finance and data-driven lending will trigger more innovations. As a result, a new competitive pattern is expected to emerge.

### **SMALL AND MEDIUM RURAL FINANCIAL INSTITUTIONS UNDER CBRC REGULATION**

Among others, rural finance was one of the main areas that witnessed the fiercest competition and dynamic change. As the mainstream suppliers of credit to the rural and agri-related sectors, small and medium rural financial institutions under CBRC's regulation (including rural cooperative FIs and new-type rural FIs) had total assets of RMB 22.12 trillion by the end of 2014, a 16.46% increase from the previous year. According to CBRC statistics, the total outstanding MSME loans for rural commercial banks, rural credit cooperatives and VTBs was around RMB 5.36 trillion.

**In 2014, the overall environment in rural areas continued to improve.** Thanks to the joint efforts of multiple government departments, information services and e-commerce in rural areas were further developed. Accessibility of basic financial services was improved. PBOC's statistics indicate that the average number of bank cards per person in rural areas reached 1.95. More than 900,000 cash service outlets covered more than 85% of villages. Reform of the rural title system (ownership of collective land, usage rights of collective land, rural land contractual management rights and title to rural residential buildings) continued to unlock development potential. A series of policies for rural financial inclusion also improved financial services in rural areas.

**Demand for rural financial services is changing.** A new trend also emerged as more people flowed back to the rural areas to start-up their own businesses. Penetration of e-commerce in rural areas stimulated rural consumption and a flow of agricultural products. Alibaba announced its aggressive plan to set up a network of 1,000 county level operational hubs and 100,000 village level service outlets in 3-5 years. The total investment would be RMB 10 billion. These trends will definitely change the demand for financing in rural areas.

**Traditional rural FIs confronted a number of competitors and challenges.** With the further down-scaling of larger commercial banks, they were gradually pushed out from urban areas and back into rural markets. E-commerce giants like Alibaba, Suning and JD are also aggressively tackling the rural MSME finance market through their financing schemes. They enjoy natural advantages with the data pools on their platforms. New financing modes like peer-to-peer (P2P) and crowd funding were also used to finance rural and agricultural production. In addition, large agricultural corporates like New Hope also provided finance to farmers as a way to strengthen their supply chains.

Rural FIs managed to keep the dominant position in rural finance in 2014. Many of them made active innovations in products and services. However, as a whole, traditional rural FIs will need to become more responsive to market changes. Cooperation with new types of suppliers might be one practical way to maintain their dominance in rural areas.

While there are still gaps in rural finance in terms of total credit amount, general accessibility and product design, it is hoped that the collaboration and competition of various suppliers will greatly benefit rural MSMEs.

## **POLICY RECOMMENDATIONS**

It is expected that MSME development will remain a priority for China and MSME finance will continue to be a hotspot for various stakeholders. The report made a number of policy recommendations, covering the following areas:

1. Improve statistical and disclosure mechanisms for MSME finance as the basis for future policy adjustments;
2. Develop more systematic and transparent incentive mechanisms for MSME finance through collaboration between various government bodies;
3. Promote a multi-layered, diversified MSME finance market, providing more financing channels for MSMEs;
4. Continuously improve financial infrastructure, including a regulated and competitive credit reporting industry and a centralized collateral registry;
5. Improve the legal and regulatory framework for the healthy development of private sector financial institutions; and
6. Create a favorable environment for MSMEs as a foundation for financial services.

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