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Addressing the SME Finance Problem

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Despite the importance of small and medium enterprises (SMEs) to economic activity and employment, their access to finance remains limited. Many countries are addressing this issue by implementing innovative instruments to unlock SME finance.

The SME Finance Problem

Although SMEs provide employment to a large share of the labor force in developed and developing countries, they receive limited external funding compared to large firms and face a financing gap. This problem is not specific to developing countries; SMEs in developed countries also suffer from a similar shortfall in financing. According to the World Bank Enterprise Survey, SMEs are less likely to have a formal bank loan or other lines of credit compared to large firms (figure 1). The International Finance Corporation (IFC) estimates that in aggregate across developing regions, the credit gap to formal SMEs ranged from $900 to $1,100 billion in 2011.[1] These values represented between 26 and 32 percent of total credit to formal SMEs (figure 2).

This policy brief explores two questions. Why are SMEs more financially constrained than large firms? What are some feasible and innovative solutions to help SMEs obtain better access to finance? Understanding the SME finance problem is critical because difficulties in obtaining finance can hamper the ability of established smaller firms to invest and grow and of new firms to launch operations, hindering overall growth in economic activity and employment.

A Supply or Demand Problem?

Both supply and demand factors can explain the low observed use of banking services by SMEs. A supply-side problem occurs when SMEs have profitable investment projects but cannot get sufficient external funds to finance them. Market imperfections, such as information asymmetries or weak creditor protection, could make it more difficult for financial intermediaries to assess the creditworthiness of SMEs, monitor their actions, and enforce repayment. These types of imperfections can limit lending to firms, including those with profitable investment opportunities. A demand-side problem exists when SMEs are not creditworthy. In this case, unless lending is subsidized, creditors will not extend credit because they would incur in losses.

Although demand-side problems occur, supply-side constraints are much more prevalent. Evidence shows that a high proportion of SMEs need a loan but refrain from applying for credit. This is the case for 20 percent of SMEs in high-income countries, 28 percent of SMEs in middle-income countries, and 44 percent of SMEs in low-income countries (World Bank 2013). Whereas some SMEs exclude themselves because they lack profitable investment projects, others perceive that their credit application will not succeed because, for example, they lack enough collateral or cannot provide all the required information.

Obstacles to SME Finance

Several roadblocks stand in the way of SME finance. SMEs typically are more "opaque" than large firms because they have less publicly available information. As a result, banks have more difficulties in assessing the creditworthiness of SMEs, which can discourage lending to these firms.

Opaqueness also requires banks to rely more on relationship lending when dealing with SMEs. This means that lending depends more on "soft information" gathered by loan officers through personalized contacts. Relationship lending can discourage loans by large and foreign banks, which maintain more impersonal relations with clients. However, new technologies are reducing the need for relationship lending and facilitating lending to SMEs using "hard (more quantitative) information" (de la Torre, Martínez Pería, and Schmukler 2010).

Lenders can substitute the lack of information on SMEs with higher requirements for collateral. But banks will be willing to provide collateralized loans only when appropriate institutions exist to enforce contracts. These institutions need to clearly establish which assets can be collateralized, protect creditors' rights, and guarantee swift judicial procedures, among other provisions. As a result, when property rights are weak, SMEs will be more financially constrained than large firms (Beck, Demirgüç-Kunt, and Maksimovic 2008).

The macroeconomic environment can also hamper SME finance. For example, if the government runs a fiscal deficit, banks might find it more profitable or less risky to fund the government instead of lending to the private sector. This could reduce the credit available to SMEs.

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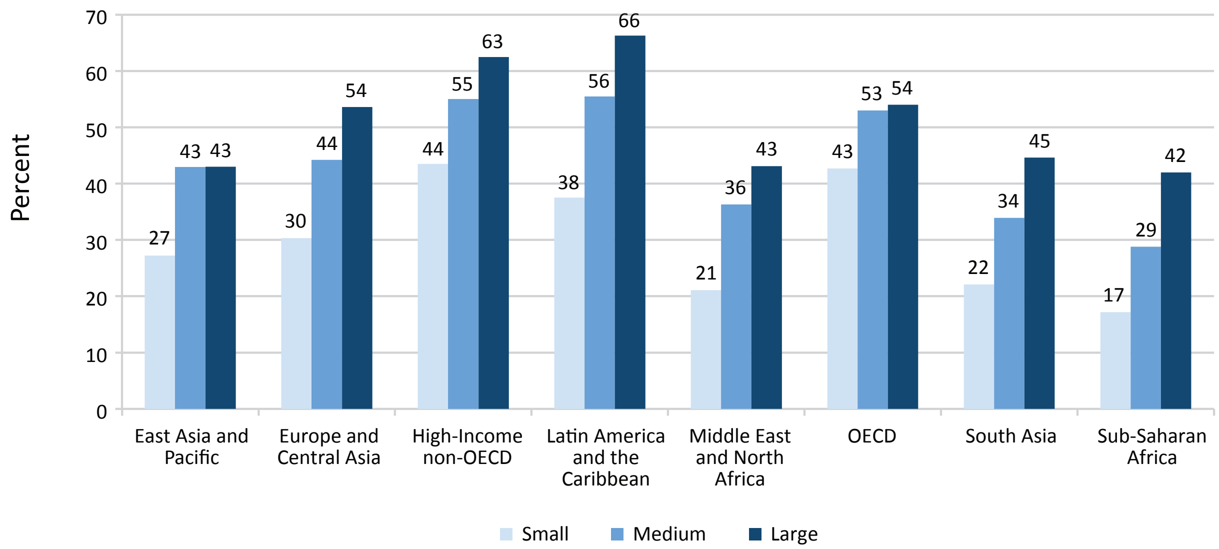
Figure 1. Use of Formal Credit by Firm Size



Source: World Bank Enterprise Survey.
This figure shows for each region the cross-country average of the percentage of firms that have a credit line or a loan from a financial institution, according to firm size. For each country, data for the last available date was considered. The years of country-data range between 2005 and 2016.

Financial regulations that require banks to keep detailed information on clients and loan originations could also limit lending to smaller firms. For example, anti-money laundering regulations that mandate banks to have detailed documentation on their customers might exclude smaller and informal SMEs from the loan market.

The nature of SMEs can also hinder lending. SMEs tend to be young and banks typically require at least two years of accounting records. SMEs in innovative sectors face additional financial constraints because banks are reluctant to lend to unfamiliar sectors. Many SMEs are also informal (not legally registered or licensed), which prevents banks from serving them.

Innovative Initiatives to Increase SME Finance

Public Credit Guarantees

Credit guarantee schemes are mechanisms through which an external third party, known as the guarantor, promises to repay the lender all or part of the loan if the borrower defaults. When a credit is guaranteed, the creditor faces lower risk, and can offer better lending conditions and require lower collateral.

Public credit guarantees have become a popular tool used by governments to channel credit toward SMEs. A survey of credit guarantee schemes around the world shows that over 30 percent of these schemes have some form of state ownership. Public credit guarantee schemes are particularly important in developing countries, where they are the main type of guarantee scheme (Beck, Klapper, and Mendoza 2010). Governments often get involved in these schemes in two different ways: by supporting private guarantee schemes (with direct funding, counter-guarantees, and/or tax incentives) or directly administering their own schemes.

Despite their popularity, the evidence on the impact of credit guarantees is mixed. There is some evidence that these mechanisms can increase loans and enhance financing conditions to targeted firms. However, they can also be associated with lower creditworthiness and higher defaults. Banks may simply shift from unguaranteed to guaranteed lending, generating no or limited new lending. Whereas in some countries firms that receive guaranteed loans have improved their performance, in others, SMEs' performance did not change or even worsened (Gozzi and Schmukler 2015).

Online Platforms for Reverse Factoring

Online platforms for conducting reverse factoring transactions are facilitating supply-chain finance to SMEs. After making a sale, SMEs often receive account receivables from their buyers, which are typically paid months after the goods are delivered. Online platforms allow SMEs to shorten the maturity of these payments by making it easier for firms to sell their account receivables to financial institutions in exchange for cash. Large, well-known buyers can post online the accounts payable they receive from their SMEs suppliers. Interested financial institutions then submit offers to buy them at a discount. SMEs accept the most convenient offer and automatically receive payment to their bank account. Using online platforms reduces transaction costs and fosters competition. Furthermore, because buyers enter information on the receivables into the system, SMEs cannot submit bogus or duplicate receivables, which reduces fraud. Credit risk is also reduced because financial institutions bear the risk of the buyers (usually creditworthy firms) instead of the risker SMEs.

Governments have developed successful online platforms. A leading example is a development bank in Mexico, NAFIN (Nacional Financiera), which has operated its own online platform for supply-chain finance since 2001. NAFIN only administers the platform and does not give lending directly, which is provided by private banks. As of 2015, the program encompassed about 12,000 suppliers, over 600 buyers, and about 40 private financing institutions. Due to its success, NAFIN has entered into agreements with other Latin American development banks to develop reverse factoring systems in Central America, Colombia, and Ecuador (de la Torre, Gozzi, and Schmukler 2017). Nowadays, these automated systems are also being offered by fintech (financial technology) companies, as well as new ventures set up by traditional banks, in both developed and developing countries (The Economist 2017).

Movable Collateral

Movable assets (such as machinery, and accounts receivables) account for most of a firm's assets, particularly for SMEs. However, due to weak legal and regulatory environments, banks are often reluctant to accept these assets as collateral, especially in developing countries. In this context, banks prefer immovable assets, which are more difficult to hide and are less likely to be subject to ownership disputes, as collateral.

In this context, several countries have pursued reforms of their secured transactions systems, that is, the legal and institutional structures that govern how agents can create security interests over movable assets (Alvarez de la Campa 2013). Reforms aimed at fostering the use of movable assets tend to expand finance to SMEs. Improving movable collateral laws increases borrowing by firms that rely more on movable assets (Campello and Larraín 2016). In addition, after collateral registries are introduced as part of the initiatives to foster the use of movable collateral, firms receive more financing at lower costs (Love, Martínez Pería, and Singh, 2016).

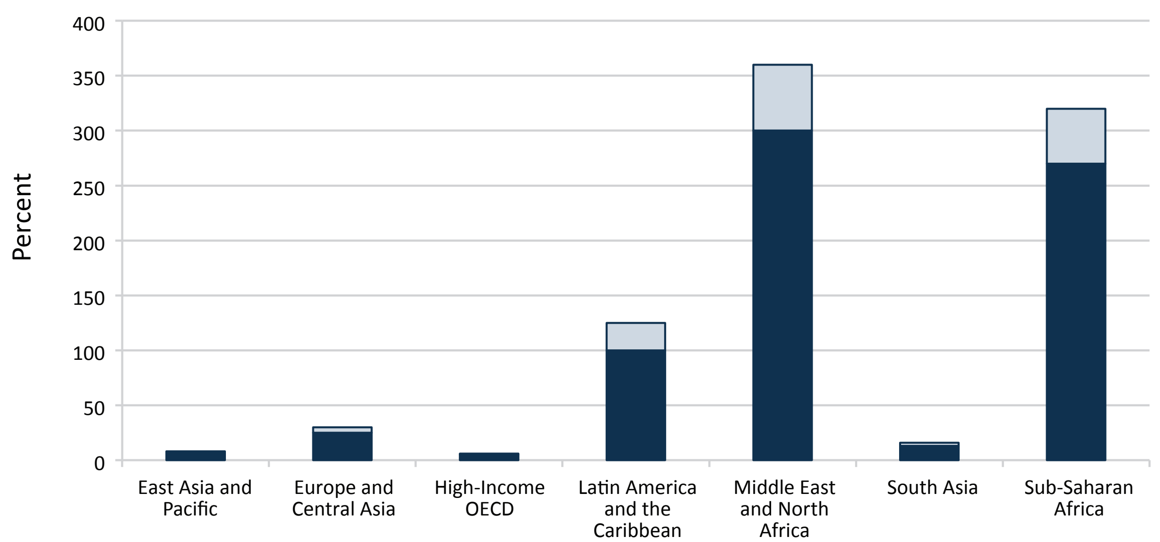
Credit Bureaus and Credit Registries

Mechanisms that allow creditors to share information about the creditworthiness of borrowers have also been used to promote SME finance through different channels. By allowing lenders to share relevant information from borrowers with other lenders, these mechanisms reduce information asymmetries in SME lending. Furthermore, they increase bank competition because they reduce lenders' monopoly on credit information (OECD 2012).

Credit information sharing mechanisms can take the form of credit registries and credit bureaus. Credit registries are managed by the public sector (typically, bank supervisors or central banks) and collect information from supervised financial institutions. By contrast, credit bureaus are private businesses that collect information required by commercial lenders. Credit bureaus have some advantages because, as for-profit organizations, they have incentives to provide wide coverage, collect quality information, and offer value-added services. One drawback is that the information might not be available to everyone.

Evidence shows that SMEs benefit the most from these mechanisms. Improving information sharing mechanisms reduces the financing gap between large and small firms, and expands credit to small firms that face credit

Figure 2. Credit Gap to Formal SMEs



Source: Stein et al. (2013).
This figure shows for each region the credit gap to formal SMEs as percentage of total oustanding credit to formal SMEs. For each region, the minimum and maximum estimated values are indicated. Data are for 2011.

constraints (Berger, Frame, and Miller 2005; Galindo and Micco 2010).

Capital Markets Tailored to SMEs

Governments have tried to circumvent banks by developing specific capital markets targeted at SMEs. These markets offer listing and regulatory requirements tailored to smaller firms such as lower fees, lower profitability requirements, and smaller issuances.

Despite the initial enthusiasm to promote these markets worldwide, these markets seem to be reaching a small number of firms (Harwood and Konidaris 2015). Asia provides a good example of these difficulties. Since the late 1990s, various countries throughout the region have set up specific capital markets targeted at smaller firms. However, these markets have generally only appealed to a small number of SMEs. For example, as of 2014, only 4 firms were listed in SME capital markets in the Philippines, 88 in India, 107 in Malaysia, and 111 in Thailand. Similar patterns can be observed in developing countries from other regions (WFE 2015). In the midst of these unsuccessful experiences, the case of China is worth analyzing, given its undergoing efforts to establish these markets.

The underdevelopment of these markets could be due to some SMEs' lack of financial literacy, which discourages them from turning to capital markets for funds. Other SMEs might feel that the benefits of listings are offset by the short-termism and volatility of these markets, and the loss of control of their firms. These markets have also had difficulties attracting institutional investors, which are the main participants in capital markets but favor large, liquid companies, whose securities can be disposed of on short notice without affecting their price (OECD 2015).

Next Steps

The initiatives discussed illustrate the different tools that countries around the world have at their disposal to try to unlock SME finance. These initiatives complement other government efforts to support SMEs, such as the provision of technical assistance to enhance their business practices.

Designing effective policy interventions requires having accurate and extensive information on the state of SME finance and the nature of the SME finance problem in each country. Better information enables governments to identify cases when SMEs are not being adequately served by the financial sector. Information also helps determine the extent to which the lack of financing to SMEs is caused by supply-side problems or demand-side problems, which kinds of intervention might be more appropriate, and the impact of these interventions. More information is also helping traditional financial firms as well as the fintech sector reach out to SMEs. Governments might want to assist these efforts by fostering the collection and use of information on the financing needs of SMEs and by supporting alternative financing mechanisms.

Policy initiatives aimed at enhancing access to credit for SMEs would benefit from experimentation as well as systematic and rigorous impact evaluations of the ongoing efforts. The challenge has been well identified across the world, but solutions have yet to be properly vetted and continuously monitored.

Note

[1] *The credit gap is defined as the amount of credit that would be needed to satisfy the demand of unserved and underserved formal SMEs. Unserved SMEs are those that do not have a loan but need one. Underserved SMEs are those that have a loan but still find access to finance to be an operating constraint.*

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